

AMERICA'S PENSIONS: THE NEXT SAVINGS AND LOAN CRISIS?

HEARING BEFORE THE SPECIAL COMMITTEE ON AGING UNITED STATES SENATE ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

WASHINGTON, DC

OCTOBER 14, 2003

Serial No. 108-24

Printed for the use of the Special Committee on Aging



U.S. GOVERNMENT PRINTING OFFICE

91-380 PDF

WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

SPECIAL COMMITTEE ON AGING

LARRY CRAIG, Idaho, *Chairman*

RICHARD SHELBY, Alabama

SUSAN COLLINS, Maine

MIKE ENZI, Wyoming

GORDON SMITH, Oregon

JAMES M. TALENT, Missouri

PETER G. FITZGERALD, Illinois

ORRIN G. HATCH, Utah

ELIZABETH DOLE, North Carolina

TED STEVENS, Alaska

RICK SANTORUM, Pennsylvania

JOHN B. BREAU, Louisiana, *Ranking*

Member

HARRY REID, Nevada

HERB KOHL, Wisconsin

JAMES M. JEFFORDS, Vermont

RUSSELL D. FEINGOLD, Wisconsin

RON WYDEN, Oregon

BLANCHE L. LINCOLN, Arkansas

EVAN BAYH, Indiana

THOMAS R. CARPER, Delaware

DEBBIE STABENOW, Michigan

LUPE WISSEL, *Staff Director*

MICHELLE EASTON, *Ranking Member Staff Director*

CONTENTS

Opening statement of Senator Larry E. Craig	Page 1
PANEL I	
Barbara Bovbjerg, General Accounting Office, Washington, DC	2
Steve Kandarian, Executive Director, Pension Benefit Guarantee Corporation, Washington, DC	47
Mark Warshawsky, Acting Assistant Secretary, Department of the Treasury, Washington, DC; accompanied by William Sweetnam, Benefits Tax Counsel, Department of the Treasury, Washington, DC	70
PANEL II	
Scott Macey, Senior President, Aon Consulting, Somerset, NJ	96
David John, Research Fellow, Heritage Foundation, Washington, DC	118
Melvin Schmeiser, Steelworker Retiree, Baltimore, MD	129
APPENDIX	
Prepared Statement of Senator Debbie Stabenow	147

AMERICA'S PENSIONS: THE NEXT SAVINGS AND LOAN CRISIS?

TUESDAY, OCTOBER 14, 2003

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Larry Craig (chairman of the committee) presiding.

Present: Senators Craig and Carper.

OPENING STATEMENT OF SENATOR LARRY E. CRAIG, CHAIRMAN

The CHAIRMAN. Good morning, ladies and gentlemen.

I would like to thank our witnesses for joining us today in our quest to strengthen the pension security of America's workers.

Today's hearing title asks the question of whether the defined benefits pension system is on a path we have seen before, with Government-backed insurance, taxpayer bail out of the savings and loan industry. Or is it different?

In the 1980's, the Federal Government stepped in to bail out the savings and loan industry at a cost of 120 billion taxpayer dollars. Of course, the details of pensions and the savings and loan situation differ in many ways, but the result could eventually be the same if we do not engage in thoughtful consideration of the issues at hand. Clearly, we do not want to repeat the savings and loan issue.

Pension policy requires the Congress to balance three competing policy goals: protect taxpayers from having to bail out the Pension Benefit Guarantee Corporation, provide sufficient incentives for industry to continue offering defined benefit pensions for their workers, and ensure workers get the pensions they are promised by their employers.

This hearing is convened in the spirit of building the record on the future of pension security, an issue that is so important to those about to retire and for younger generations.

With that I am very pleased to welcome these distinguished witnesses to the Senate Special Committee on Aging this morning. We appreciate you taking time from your schedule to work with us in building this record.

Our first witnesses on the panel are Barbara Bovbjerg who is the Director of Education, Workforce and Income Security at the General Accounting Office. Barbara, welcome.

Steve Kandarian—I do not want to massacre names too badly, Steve—Executive Director of the Pension Benefit Guarantee Corporation. Peter Warshawsky, Acting Assistant Secretary of Economics at the Department of Treasury. Steve, you have brought another gentlemen with you, William Sweetnam, from Treasury, who make up our first panel today. So again, we thank you for being with us. We will move right into your testimony. Barbara, if you would please start?

**STATEMENT OF BARBARA BOVBJERG, GENERAL ACCOUNTING
OFFICE, WASHINGTON, DC**

Ms. BOVBJERG. Thank you, Mr. Chairman.

I appreciate your inviting me here today to discuss issues associated with ensuring defined benefit pension plans. The Pension Benefit Guarantee Corporation's single employer program insures benefits of more than 34 million workers and retirees but after accumulating surpluses for several years, last year reported a \$3.6 billion deficit with the prospect for several billion more this year.

You have asked me here today to discuss the implications of this financial reversal and what might be done to address it. I will speak briefly about three things: the immediate causes of this problem, future prospects for the program, and options for policy change.

My testimony is based on information gathered from the PBGC, from interviews with pension experts, and our analysis of several individual plans that presented large losses to PBGC. The Controller General has testified earlier about these issues before our requesters on the House Education and Workforce Committee, and we will report the final results of this work later this month.

First, the causes. PBGC's single employer program fell into deficit in response to the termination of several severely underfunded pension plans. The sharp decline of the stock market reduced the plans asset values. This, together with low interest rates which raised plan liability values, dramatically worsened the financial position of many plans during a period when several companies with large plans failed.

The experience of Bethlehem Steel, which represents the largest hit ever to PBGC funds, can be illustrative. This chart shows Bethlehem's assets and liabilities as the vertical bars and the percentage of the plan's funding as the heavy line.

As you can see from the position of the line, in 1999 Bethlehem reported nearly full funding for its plans. But by 2002, only 3 years later, when it terminated its plan assets were less than half the value of plan liabilities. This happened in part because over 70 percent of the plan assets were in stock when the markets lost value.

Yet, as the next chart shows, even though plan assets were falling and estimated liabilities rising, Bethlehem Steel made no contributions to its plans in 2000, 2001, or 2002. This is because plans that have exceeded minimum contributions in the past earn funding credits that can offset minimum contributions for the future. Bethlehem had built up funding credits such that the company was legally permitted to contribute nothing to its plan at precisely the time the plan's funding status was becoming untenable. Minimum

funding rules, which are designed to encourage plan sponsors to fully fund their plans, clearly proved ineffective.

Variable rate premiums are designed to encourage employers to fund their plans adequately. But as you will see in this last chart, Bethlehem paid only the flat rate premium from 1998 on because the plan, by meeting full funding standards through 2000, was exempt from the higher premium payments until 2002, at which time the plan was terminated. Pretty clearly, variable rate premiums are ineffective when plan funding status changes as quickly as it did here.

Let me move now to the future. Of course, PBGC remains vulnerable to the same conditions that underlay the Bethlehem case. While the cyclical economic conditions that worsened plan and PBGC finances will eventually improve, it is also important to understand that we are in an environment where employers large and small have exited the defined benefit system while newer firms have generally chosen other pension vehicles. This has left PBGC with a risk pool of employers that is concentrated in sectors of the economy like airlines, automobiles, and steel which have become economically vulnerable.

These developments have important and worrisome implications for the future and the magnitude of the risk that PBGC insures. It is with this larger picture in mind the GAO has placed PBGC's program on the high-risk list.

Let me now turn to options for change. Several types of reforms could be considered and they fall into four categories: strengthening funding rules, modifying program guarantees, restructuring premiums, and increasing transparency. There are a variety of options within each category and each has advantages and disadvantages. However, anything that would increase contributions for plan sponsors who may themselves be in financial difficulty could further weaken the sponsor while at the same time discouraging healthier companies from providing DB pensions at all.

In addressing the challenge to PBGC, it will be important to understand that its long-term financial health is inextricably bound to the underlying health of the DB pension system itself. Options that serve to revitalize the DB system could stabilize PBGC's finances, although this could only take place over the long-term. More immediately, Congress could consider developing a comprehensive solution to PBGC's risks that adequately balances employer concerns with improvements to employer accountability for funding and reporting.

GAO is giving this program and its needs special scrutiny in the immediate future and will be pleased to help Congress in this endeavor. That concludes my statement, Mr. Chairman, and I would be happy to answer questions.

[The prepared statement of Ms. Bovbjerg follows:]

GAO

United States General Accounting Office

Testimony
Before the Special Committee on Aging,
United States Senate

For Release on Delivery
Expected at 10:00 a.m.
Tuesday, October 14, 2003

**PENSION BENEFIT
GUARANTY
CORPORATION**

**Long-Term Financing Risks
to Single-Employer
Insurance Program
Highlight Need for
Comprehensive Reform**

Statement of Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security



GAO-04-150T

GAO
Accountability Integrity Reliability
Highlights

Highlights of GAO-04-150T, a testimony before the Special Committee on Aging, U.S. Senate.

Why GAO Did This Study

More than 34 million workers and retirees in 30,000 single-employer defined benefit pension plans rely on a federal insurance program managed by the Pension Benefit Guaranty Corporation (PBGC) to protect their pension benefits, and the program's long-term financial viability is in doubt. Over the last decade, the program swung from a \$3.6 billion accumulated deficit (liabilities exceeded assets), to a \$10.1 billion accumulated surplus, and back to a \$3.6 billion accumulated deficit, in 2002 dollars. Furthermore, despite a record \$9 billion in estimated losses to the program in 2002, additional severe losses may be on the horizon. PBGC estimates that financially weak companies sponsor plans with \$35 billion in unfunded benefits, which ultimately might become losses to the program.

This testimony provides GAO's observations on the factors that contributed to recent changes in the single-employer pension insurance program's financial condition, risks to the program's long-term financial viability, and changes to the program that might be considered to reduce those risks.

www.gao.gov/cgi-bin/gettrpt?GAO-04-150T

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovjergb@gao.gov.

October 14, 2003

PENSION BENEFIT GUARANTY CORPORATION

Long-Term Financing Risks to Single-Employer Insurance Program Highlight Need for Comprehensive Reform

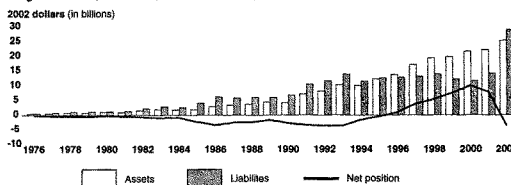
What GAO Found

The single-employer pension insurance program returned to an accumulated deficit in 2002 largely due to the termination, or expected termination, of several severely underfunded pension plans. Factors that contributed to the severity of plans' underfunded condition included a sharp stock market decline, which reduced plan assets, and an interest rate decline, which increased plan termination costs. For example, PBGC estimates losses to the program from terminating the Bethlehem Steel pension plan, which was nearly fully funded in 1989 based on reports to IRS, at \$3.7 billion when it was terminated in 2002. The plan's assets had decreased by over \$2.5 billion, while its liabilities had increased by about \$1.4 billion since 1989.

The single-employer program faces two primary risks to its long-term financial viability. First, the losses experienced in 2002 could continue or accelerate if, for example, structural problems in particular industries result in additional bankruptcies. Second, revenue from premiums and investments might be inadequate to offset program losses experienced to date or those that occur in the future. Revenue from premiums might fall, for example, if the number of program participants decreases. Because of these risks, we recently placed the single-employer insurance program on our high-risk list of agencies with significant vulnerabilities to the federal government.

While there is not an immediate crisis, there is a serious problem threatening the retirement security of millions of American workers and retirees. Several reforms might reduce the risks to the program's long-term financial viability. Such changes include: strengthening funding rules applicable to poorly funded plans, modifying program guarantees, restructuring premiums, and improving the availability of information about plan investments, termination funding, and program guarantees. Any changes adopted to address the challenge facing PBGC should provide a means to hold plan sponsors accountable for adequately funding their plans, provide plan sponsors with incentives to increase plan funding, and improve the transparency of plan information.

Program Assets, Liabilities, and Net Position, Fiscal Years 1976-2002



Source: PBGC annual reports.

United States General Accounting Office

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the serious financial challenges facing the Pension Benefit Guaranty Corporation's (PBGCs) single-employer insurance program. This federal program insures the benefits of the more than 34 million workers and retirees participating in private defined-benefit pension plans.¹ Over the last few years, the finances of PBGC's single-employer insurance program,² have taken a severe turn for the worse. From a \$3.6 billion accumulated deficit in 1993, the program registered a \$10.1 billion accumulated surplus (assets exceeded liabilities) in 2000 before returning to a \$3.6 billion accumulated deficit, in 2002 dollars.³ More fundamentally, the long-term viability of the program is at risk. Even after assuming responsibility for several severely underfunded pension plans and recording over \$9 billion in estimated losses in 2002, PBGC estimated that as of September 30, 2002, it faced exposure to approximately \$35 billion in additional unfunded liabilities from ongoing plans that were sponsored by financially weak companies and may terminate.⁴

¹A defined-benefit plan promises a benefit that is generally based on an employee's salary and years of service. The employer is responsible for funding the benefit, investing and managing plan assets, and bearing the investment risk. In contrast, under a defined contribution plan, benefits are based on the contributions to and investment returns on individual accounts, and the employee bears the investment risk.

²There are two federal insurance programs for defined-benefit plans: one for single-employer plans and another for multiemployer plans. Our work was limited to the PBGC program to insure the benefits promised by single-employer defined-benefit pension plans. Single-employer plans provide benefits to employees of one firm or, if plan terms are not collectively bargained, employees of several related firms.

³PBGC estimates that its deficit had grown to about \$5.7 billion at the end of July 2003 based on its latest unaudited financial report.

⁴PBGC estimates that by the end of fiscal year 2003, the amount of underfunding in financially troubled companies could exceed \$80 billion. According to PBGC, for example, companies whose credit quality is below investment grade sponsor a number of plans. PBGC classifies such plans as reasonably possible terminations if the sponsors' financial condition and other factors did not indicate that termination of their plans was likely as of year-end. See PBGC 2002 Annual Report, p. 41. The independent accountants that audited PBGC's financial statement reported that PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable and reasonably possible plan terminations. According to an official, PBGC has implemented new procedures focused on improving these controls. See Audit of the Pension Benefit Guaranty Corporation's Fiscal Year 2002 and 2001 Financial Statements in PBGC Office of Inspector General Audit Report, 2003-3/23168-2 (Washington, D.C.: Jan. 30, 2003).

This risk involves an issue beyond PBGC's current and future financial condition; it also relates to the need to protect the retirement security of millions of American workers and retirees. I hope my testimony will help clarify some of the key issues in the debate about how to respond to the financial challenges facing the federal insurance program for single-employer defined-benefit plans. As you requested, I will discuss (1) the factors that contributed to recent changes in the single-employer pension insurance program's financial condition, (2) risks to the program's long-term financial viability, and (3) changes to the program that might be considered to reduce those risks.

To identify the factors that contributed to recent changes in the single-employer program's financial condition, we discussed with PBGC officials, and examined annual reports and other available information related to the funding and termination of three pension plans: the Anchor Glass Container Corporation Service Retirement Plan, the Pension Plan of Bethlehem Steel Corporation and Subsidiary Companies, and the Polaroid Pension Plan. We selected these plans because they represented the largest losses to PBGC in their respective industries in fiscal year 2002. PBGC estimates that, collectively, the plans represented over \$4 billion in losses to the program at plan termination. In particular, I will focus on the experience of the Bethlehem Steel plan because it provides such a vivid illustration of the immediate and long-term challenges to the program and the need for additional reforms. To identify the primary risks to the long-term viability of the program and options to address the challenges facing the single-employer program, we interviewed pension experts at PBGC, at the Employee Benefits Security Administration of the Department of Labor, and in the private sector and reviewed analyses and other documents provided by them. To obtain additional information as to the risks facing PBGC from certain industries, we discussed with PBGC, and reviewed annual and actuarial reports for the 2003 distress termination of the U.S. Airways pension plan for pilots. To determine what changes might be considered to reduce those risks, we reviewed proposals for reforming the single-employer program made by the Department of the Treasury, PBGC, and pension professionals.

Let me first summarize my responses to your questions. The termination, or expected termination, of several severely underfunded pension plans was the major reason for PBGC's single-employer pension insurance program's return to an accumulated deficit in 2002. Several underlying factors contributed to the severity of the plans' underfunded condition at termination, including a sharp decline in the stock market, which reduced plan asset values, and a general decline in interest rates, which increased

the cost of terminating defined-benefit pension plans. Falling stock prices and interest rates can dramatically reduce plan funding as the sponsor approaches bankruptcy. For example, while annual reports indicated the Bethlehem Steel Corporation pension plan was almost fully funded in 1999 based on reports to IRS, PBGC estimates that the value of the plan's assets was less than 50 percent of the value of its guaranteed liabilities by the time it was terminated in 2002. The current minimum funding rules and other rules designed to encourage sponsors to fully fund their plans were not effective at preventing it from being severely underfunded at termination.

Two primary risks could affect the long-term financial viability of the single-employer program. First, and most worrisome, the high level of losses experienced in 2002, due to the bankruptcy of companies with large underfunded defined-benefit pension plans, could continue or accelerate. This could occur if the economy recovers slowly or weakly, returns on plan investments remain poor, interest rates remain low, or the structural problems of particular industries with pension plans insured by PBGC result in additional bankruptcies. Second, PBGC might not receive sufficient revenue from premium payments and its own investments to offset the losses experienced to date or those that may occur in subsequent years. This could happen if participation in the single-employer program falls or if PBGC's return on assets falls below the rate it uses to calculate the present value of benefits promised in the future. Because of its current financial weaknesses, as well as the serious, long-term risks to the program's future viability, we recently placed PBGC's single-employer insurance program on our high-risk list.

While there is not an immediate crisis, there is a serious problem that needs to be addressed. Some pension professionals have suggested a "wait and see" approach, betting that brighter economic conditions might ameliorate PBGC's financial challenges. However, the recent trends in the single-employer program's financial condition illustrate the fragility of PBGC's insured plans and suggest that an improvement in plan finances due to economic recovery may not address certain fundamental weaknesses and risks facing the single-employer insurance program. Agency officials and other pension professionals have suggested taking a more proactive approach and have identified a variety of options to address the challenges facing PBGC's single-employer program. In our view, several reforms might be considered to reduce the risks to the single-employer program's long-term financial viability. These include strengthening funding rules applicable to poorly funded plans, modifying program guarantees, restructuring premiums, and improving the

availability of information about plan investments, termination funding, and program guarantees. Under each reform, several possible actions could be taken. For example, one way to modify program guarantees is to phase-in certain unfunded benefits, such as "shutdown benefits." In addition, one way premiums could be restructured would be to base them, not only on the degree of plan underfunding, but also on the economic strength of the plan sponsor, the degree of risk to the plan's investment portfolio, the plan's benefit structure, and participant demographics. These options are not mutually exclusive, either in combination or individually and several variations exist within each. Each option also has advantages and disadvantages. In any event, any changes adopted to address the challenge facing PBGC should provide a means to hold sponsors accountable for adequately funding their plans, provide plan sponsors with incentives to increase plan funding, and improve the transparency of the plan's financial information.

Background

Before enactment of the Employee Retirement and Income Security Act (ERISA) of 1974, few rules governed the funding of defined benefit pension plans, and participants in these plans had no guarantees they would receive the benefits promised. When Studebaker's pension plan failed in the 1960s, for example, many plan participants lost their pensions.⁴ Such experiences prompted the passage of ERISA to better protect the retirement savings of Americans covered by private pension plans. Along with other changes, ERISA established PBGC to pay the pension benefits of participants, subject to certain limits, in the event that an employer could not.⁵ ERISA also required PBGC to encourage the continuation and maintenance of voluntary private pension plans and to maintain premiums set by the corporation at the lowest level consistent with carrying out its obligations.⁶

⁴The company and the union agreed to terminate the plan along the lines set out in the collective bargaining agreement: retirees and retirement eligible employees over age 60 received full pensions and vested employees under age 60 received a lump-sum payment worth about 15 percent of the value of their pensions. Employees, whose benefit accruals had not vested, including all employees under age 40, received nothing. James A. Wooten, "The Most Glorious Story of Failure in Business: The Studebaker - Packard Corporation and the Origins of ERISA," *Buffalo Law Review*, vol. 49 (Buffalo, NY: 2001): 731.

⁵Some defined-benefit plans are not covered by PBGC insurance; for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer employees.

⁶See section 4002(a) of P.L. 93-406, Sep. 2, 1974.

Under ERISA, the termination of a single-employer defined-benefit plan results in an insurance claim with the single-employer program if the plan has insufficient assets to pay all benefits accrued under the plan up to the date of plan termination.⁸ PBGC may pay only a portion of the claim because ERISA places limits on the PBGC benefit guarantee. For example, PBGC generally does not guarantee annual benefits above a certain amount, currently about \$44,000 per participant at age 65.⁹ Additionally, benefit increases in the 5 years immediately preceding plan termination are not fully guaranteed, though PBGC will pay a portion of these increases.¹⁰ The guarantee is limited to certain benefits, including so-called "shut-down benefits,"—significant subsidized early retirement benefits that are triggered by layoffs or plant closings that occur before plan termination. The guarantee does not generally include supplemental benefits, such as the temporary benefits that some plans pay to participants from the time they retire until they are eligible for Social Security benefits.

Following enactment of ERISA, however, concerns were raised about the potential losses that PBGC might face from the termination of underfunded plans. To protect PBGC, ERISA was amended in 1986 to require that plan sponsors meet certain additional conditions before terminating an underfunded plan. (See app I.) For example, sponsors could voluntarily terminate their underfunded plans only if they were bankrupt or generally unable to pay their debts without the termination.

⁸The termination of a fully funded defined-benefit pension plan is termed a standard termination. Plan sponsors may terminate fully funded plans by purchasing a group annuity contract from an insurance company under which the insurance company agrees to pay all accrued benefits or by paying lump-sum benefits to participants if permissible. Terminating an underfunded plan is termed a distress termination if the plan sponsor requests the termination or an involuntary termination if PBGC initiates the termination. PBGC may institute proceedings to terminate a plan if, among other things, the plan will be unable to pay benefits when due or the possible long-run loss to PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. See 29 U.S.C. 1342(a).

⁹The amount guaranteed by PBGC is reduced for participants under age 65.

¹⁰The guaranteed amount of the benefit increase is calculated by multiplying the number of years the benefit increase has been in effect, not to exceed 5 years, by the greater of (1) 20 percent of the monthly benefit calculated in accordance with PBGC regulations or (2) \$20 per month. See 29 C.F.R. 4022.25(b).

Concerns about PBGC finances also resulted in efforts to strengthen the minimum funding rules incorporated by ERISA in the Internal Revenue Code (IRC). In 1987, for example, the IRC was amended to require that plan sponsors calculate each plan's current liability,¹¹ and make additional contributions to the plan if it is underfunded to the extent defined in the law.¹² As discussed in a report,¹³ we issued earlier this year, concerns that the 30-year Treasury bond rate no longer resulted in reasonable current liability calculations has led both the Congress and the Administration to propose alternative rates for these calculations.¹⁴

Despite the 1987 amendments to ERISA, concerns about PBGC's financial condition persisted. In 1990, as part of our effort to call attention to high-

¹¹Under the IRC, current liability means all liabilities to employees and their beneficiaries under the plan. See 26 U.S.C. 412(d)(7)(A). In calculating current liabilities, the IRC requires plans to use an interest rate from within a permissible range of rates. See 26 U.S.C. 412(b)(5)(B). In 1987, the permissible range was not more than 10 percent above, and not more than 10 percent below, the weighted average of the rates of interest on 30-year Treasury bond securities during the 4-year period ending on the last day before the beginning of the plan year. The top of the permissible range was gradually reduced by 1 percent per year beginning with the 1995 plan year to not more than 5 percent above the weighted average rate effective for plan years beginning in 1999. The top of the permissible range was increased to 20 percent above the weighted average rate for 2002 and 2003. The weighted average rate is calculated as the average yield over 48 months with rates for the most recent 12 months weighted by 4, the second most recent 12 months weighted by 3, the third most recent 12 months weighted by 2, and the fourth weighted by 1.

¹²Under the additional funding rule, a single-employer plan sponsored by an employer with more than 100 employees in defined-benefit plans is subject to a deficit reduction contribution for a plan year if the value of plan assets is less than 90 percent of its current liability. However, a plan is not subject to the deficit reduction contribution if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for each of the 2 immediately preceding years or each of the second and third immediately preceding years. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate their current liability using the highest interest rate allowable for the plan year. See 26 U.S.C. 412(i)(9)(C).

¹³U.S. General Accounting Office, *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations*, GAO-03-313 (Washington, D.C.: Feb. 27, 2003).

¹⁴The *Pension Preservation and Savings Expansion Act of 2003*, H.R. 1776, introduced April 11, 2003, would make a number of changes to the IRC to address retirement savings and private pension issues, including replacing the interest rate used for current liability calculations (currently, the rate on 30-year Treasury bonds) with a rate based on an index or indices of conservatively invested, long-term corporate bonds. In July of 2003, the Department of the Treasury unveiled *The Administration Proposal to Improve the Accuracy and Transparency of Pension Information*. Its stated purpose is to improve the accuracy of the pension liability discount rate, increase the transparency of pension plan information, and strengthen safeguards against pension underfunding.

risk areas in the federal government, we noted that weaknesses in the single-employer insurance program's financial condition threatened PBGC's long-term viability.¹⁶ We stated that minimum funding rules still did not ensure that plan sponsors would contribute enough for terminating plans to have sufficient assets to cover all promised benefits. In 1992, we also reported that PBGC had weaknesses in its internal controls and financial systems that placed the entire agency, and not just the single-employer program, at risk.¹⁷ Three years later, we reported that legislation enacted in 1994 had strengthened PBGC's program weaknesses and that we believed improvements had been significant enough for us to remove the agency's high-risk designation.¹⁸ Since that time, we have continued to monitor PBGC's financial condition and internal controls. For example, in 1998, we reported that adverse economic conditions could threaten PBGC's financial condition despite recent improvements;¹⁹ in 2000, we reported that contracting weaknesses at PBGC, if uncorrected, could result in PBGC paying too much for required services;²⁰ and this year, we reported that weaknesses in the PBGC budgeting process limited its control over administrative expenses.²¹

PBGC receives no direct federal tax dollars to support the single-employer pension insurance program. The program receives the assets of terminated underfunded plans and any of the sponsor's assets that PBGC recovers

¹⁶Letter to the Chairman, Senate Committee on Governmental Affairs and House Committee on Government Operations, GAO/OCG-90-1, Jan. 23, 1990. GAO's high-risk program has increasingly focused on those major programs and operations that need urgent attention and transformation to ensure that our national government functions in the most economical, efficient, and effective manner. Agencies or programs receiving a "high risk" designation receive greater attention from GAO and are assessed in regular reports, which generally coincide with the start of each new Congress.

¹⁶U.S. General Accounting Office, *High-Risk Series: Pension Benefit Guaranty Corporation*, GAO/HR-93-5 (Washington, D.C.: Dec. 1992).

¹⁷U.S. General Accounting Office, *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: Feb. 1995).

¹⁸U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Financial Condition Improving but Long-Term Risks Remain*, GAO/HEHS-99-5 (Washington, D.C.: Oct. 16, 1998).

¹⁹U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Contracting Management Needs Improvement*, GAO/HEHS-00-130 (Washington, D.C.: Sept. 18, 2000).

²⁰U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Statutory Limitation on Administrative Expenses Does Not Provide Meaningful Control*, GAO-03-301 (Washington, D.C.: Feb. 28, 2003).

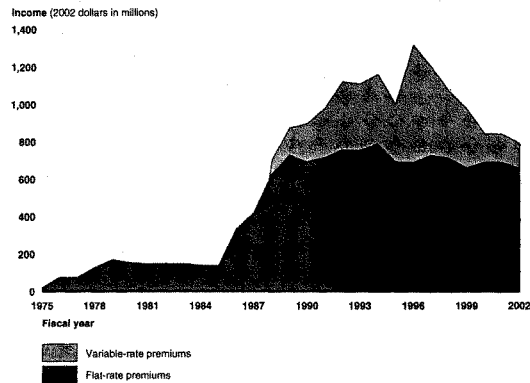
during bankruptcy proceedings.²¹ PBGC finances the unfunded liabilities of terminated plans with (1) premiums paid by plan sponsors and (2) income earned from the investment of program assets.

Initially, plan sponsors paid only a flat-rate premium of \$1 per participant per year; however, the flat rate has been increased over the years and is currently \$19 per participant per year. To provide an incentive for sponsors to better fund their plans, a variable-rate premium was added in 1987. The variable-rate premium, which started at \$6 for each \$1,000 of unfunded vested benefits, was initially capped at \$34 per participant. The variable rate was increased to \$9 for each \$1,000 of unfunded vested benefits starting in 1991, and the cap on variable-rate premiums was removed starting in 1996. After increasing sharply in the 1980s, flat-rate premium income declined from \$753 million in 1993 to \$654 million in 2002, in constant 2002 dollars.²² (See fig. 1.) Income from the variable-rate premium fluctuated widely over that period.

²¹According to PBGC officials, PBGC files a claim for all unfunded benefits in bankruptcy proceedings. However, PBGC generally recovers only a small portion of the total unfunded benefit amount in bankruptcy proceedings, and the recovered amount is split between PBGC (for unfunded guaranteed benefits) and participants (for unfunded nonguaranteed benefits).

²²In 2002 dollars, flat-rate premium income rose from \$605 million in 1993 to \$654 million in 2002.

Figure 1: Flat- and Variable-Rate Premium Income for the Single-Employer Pension Insurance Program, Fiscal Years 1975-2002

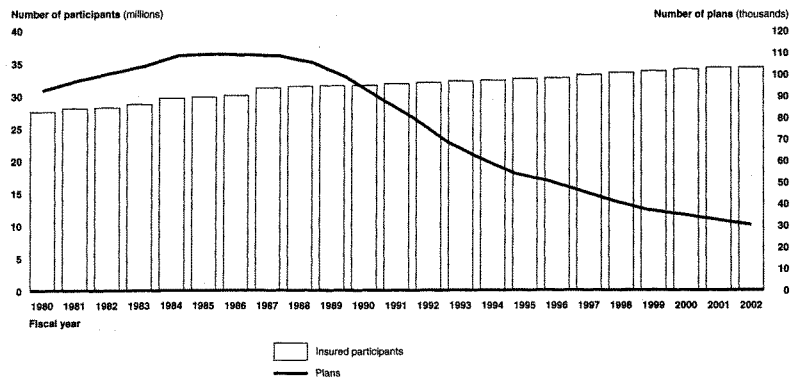


Source: PBGC.

Note: PBGC follows accrual basis accounting, and as a result, included in the fiscal year 2002 statement an estimate of variable rate premium income for the period covering January 1 through September 30, 2002, for plans whose filings were not received by September 30, 2002. We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

The slight decline in flat-rate premium revenue over the last decade, in real dollars, indicates that the increase in insured participants has not been sufficient to offset the effects of inflation over the period. Essentially, while the number of participants has grown since 1980, growth has been sluggish. Additionally, after increasing during the early 1980s, the number of insured single-employer plans has decreased dramatically since 1986. (See fig. 2.)

Figure 2: Participants and Plans Covered by the Single-Employer Insurance Program, 1980-2002



Source: PBGC.

The decline in variable-rate premiums in 2002 may be due to a number of factors. For example, all else equal, an increase in the rate used to determine the present value of benefits reduces the degree to which reports indicate plans are underfunded, which reduces variable-rate premium payments. The Job Creation and Worker Assistance Act of 2002 increased the statutory interest rate for variable-rate premium calculations from 85 percent to 100 percent of the interest rate on 30-year U.S. Treasury securities for plan years beginning after December 31, 2001, and before January 1, 2004.²³

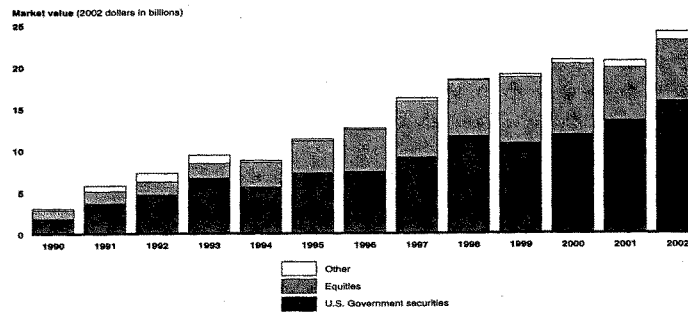
Investment income is also a large source of funds for the single-employer insurance program. The law requires PBGC to invest a portion of the funds generated by flat-rate premiums in obligations issued or guaranteed by the United States, but gives PBGC greater flexibility in the investment of other

²³See section 405, P.L. 107-147, Mar. 9, 2002.

assets.²⁴ For example, PBGC may invest funds recovered from terminated plans and plan sponsors in equities, real estate, or other securities and funds from variable-rate premiums in government or private fixed-income securities. According to PBGC, however, by policy, it invests all premium income in Treasury securities. As a result of the law and investment policies, the majority of the single-employer program's assets are invested in U.S. government securities. (See fig. 3.)

²⁴PBGC accounts for single-employer program assets in separate trust and revolving funds. PBGC accounts for the assets of terminated plans and plan sponsors in a trust fund, which, according to PBGC, may be invested in equities, real estate, or other securities. PBGC accounts for single-employer program premiums in two revolving funds. One revolving fund is used for all variable-rate premiums, and that portion of the flat-rate premium attributable to the flat-rate in excess of \$8.50. The law states that PBGC may invest this revolving fund in such obligations, as it considers appropriate. See 29 U.S.C. 1305(f). The second revolving fund is used for the remaining flat-rate premiums, and the law restricts the investment of this revolving fund to obligations issued or guaranteed by the United States. See 29 U.S.C. 1305(b)(3).

Figure 3: Market Value of Single-Employer Program Assets in Revolving and Trust Funds at Year End, Fiscal Years 1990-2002

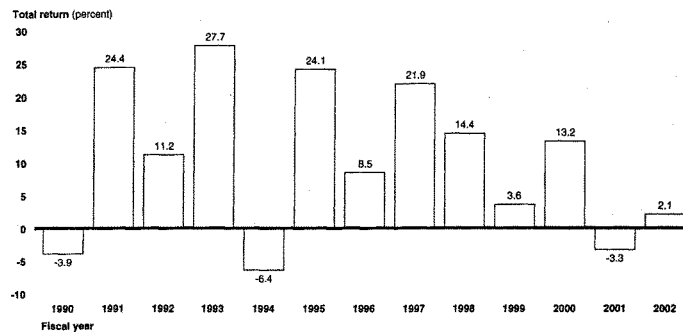


Source: PBGC annual reports.

Note: Other includes fixed-maturity securities, other than U.S. government securities, such as corporate bonds. In 2002, fixed-maturity securities, other than U.S. government securities, totaled \$946 million. We adjusted PBGC data using the Consumer Price Index for All Urban Consumers; All items.

Since 1990, except for 3 years, PBGC has achieved a positive return on the investments of single-employer program assets. (See fig 4.) According to PBGC, over the last 10 years, the total return on these investments has averaged about 10 percent.

Figure 4: Total Return on the Investment of Single-Employer Program Assets, Fiscal Years 1990-2002



For the most part, liabilities of the single-employer pension insurance program are comprised of the present value of insured participant benefits. PBGC calculates present values using interest rate factors that, along with a specified mortality table, reflect annuity prices, net of administrative expenses, obtained from surveys of insurance companies conducted by the American Council of Life Insurers.²⁶ In addition to the estimated total liabilities of underfunded plans that have actually terminated, PBGC includes in program liabilities the estimated unfunded liabilities of underfunded plans that it believes will probably terminate in the near future.²⁶ PBGC may classify an underfunded plan as a probable termination when, among other things, the plan's sponsor is in liquidation under federal or state bankruptcy laws.

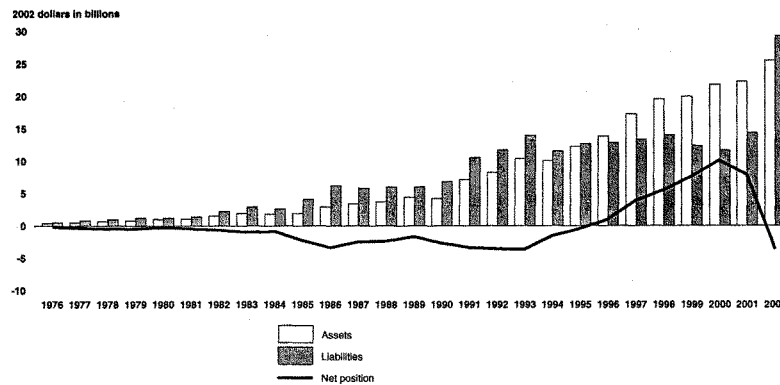
²⁵In 2002, PBGC used an interest rate factor of 5.70 percent for benefit payments through 2027 and a factor of 4.75 percent for benefit payments in the remaining years.

²⁶Under Statement of Financial Accounting Standard Number 5, loss contingencies are classified as probable if the future event or events are likely to occur.

The single-employer program has had an accumulated deficit—that is, program assets have been less than the present value of benefits and other liabilities—for much of its existence. (See fig. 5.) In fiscal year 1996, the program had its first accumulated surplus, and by fiscal year 2000, the accumulated surplus had increased to almost \$10 billion, in 2002 dollars. However, the program's finances reversed direction in 2001, and at the end of fiscal year 2002, its accumulated deficit was about \$3.6 billion. PBGC estimates that this deficit grew to \$5.7 billion by July 31, 2003. Despite this large deficit, according to a PBGC analysis, the single-employer program was estimated to have enough assets to pay benefits through 2019, given the program's conditions and PBGC assumptions as of the end of fiscal year 2002.²⁷ Losses since that time may have shortened the period over which the program will be able to cover promised benefits.

²⁷The estimate assumes: (1) a rate of return on all PBGC assets of 5.8 percent and a discount rate on future benefits of 5.87 percent; (2) no premium income and no future claims beyond all plans with terminations that were deemed "probable" as of September 30, 2002; (3) administrative expenses of \$225 million in fiscal year 2003, \$229 million per year for fiscal year 2004-14, and \$0 thereafter; (4) mid-year termination for "probables"; and (5) that PBGC does not assume control of "probable" assets and future benefits until the date of plan termination.

Figure 5: Assets, Liabilities, and Net Position of the Single-Employer Pension Insurance Program, Fiscal Years 1976-2002



Note: Amounts for 1986 do not include plans subsequently returned to a reorganized LTV Corporation. We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

Termination of Severely Underfunded Plans Was Primary Factor in Financial Decline of Single-Employer Program

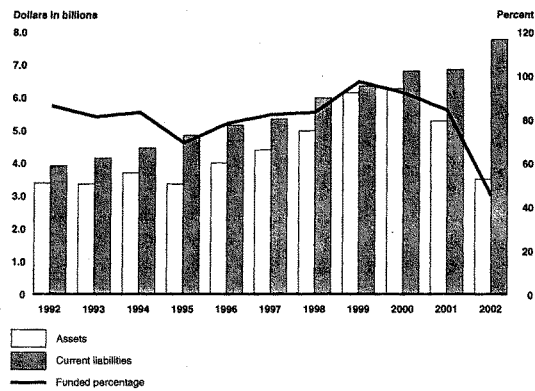
The financial condition of the single-employer pension insurance program returned to an accumulated deficit in 2002 largely due to the termination, or expected termination, of several severely underfunded pension plans. In 1992, we reported that many factors contributed to the degree plans were underfunded at termination, including the payment at termination of additional benefits, such as subsidized early retirement benefits, which have been promised to plan participants if plants or companies ceased operations.²⁸ These factors likely contributed to the degree that plans terminated in 2002 were underfunded. Factors that increased the severity of the plans' unfunded liability in 2002 were the recent sharp decline in the

²⁸U.S. General Accounting Office, *Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Programs*, GAO/HRD-93-7 (Washington, D.C.: Dec. 30, 1992).

	stock market and a general decline in interest rates. The current minimum funding rules and variable-rate premiums were not effective at preventing those plans from being severely underfunded at termination.
PBGC Assumed Responsibility for Several Severely Underfunded Plans in 2002	<p>Total estimated losses in the single-employer program due to the actual or probable termination of underfunded plans increased from \$705 million in fiscal year 2001 to \$9.3 billion in fiscal year 2002, in 2002 dollars. In addition to \$3.0 billion in losses from the unfunded liabilities of terminated plans, the \$9.3 billion included \$6.3 billion in losses from the unfunded liabilities of plans that were expected to terminate in the near future. Some of the terminations considered probable at the end of fiscal year 2002 have already occurred. For example, in December 2002, PBGC involuntarily terminated an underfunded Bethlehem Steel Corporation pension plan, which resulted in the single-employer program assuming responsibility for about \$7.2 billion in PBGC-guaranteed liabilities, about \$3.7 billion of which was not funded at termination.</p> <p>Much of the program's losses resulted from the termination of underfunded plans sponsored by failing steel companies. PBGC estimates that in 2002, underfunded steel company pension plans accounted for 80 percent of the \$9.3 billion in program losses for the year. The three largest losses in the single-employer program's history resulted from the termination of underfunded plans sponsored by failing steel companies: Bethlehem Steel, LTV Steel, and National Steel. All three plans were either completed terminations or listed as probable terminations for 2002. Giant vertically integrated steel companies, such as Bethlehem Steel, have faced extreme economic difficulty for decades, and efforts to salvage their defined-benefit plans have largely proved unsuccessful. According to PBGC's executive director, underfunded steel company pension plans have accounted for 58 percent of PBGC single-employer losses since 1975.</p>
Plan Unfunded Liabilities Were Increased by Stock Market and Interest Rate Declines	<p>The termination of underfunded plans in 2002 occurred after a sharp decline in the stock market had reduced plan asset values and a general decline in interest rates had increased plan liability values, and the sponsors did not make the contributions necessary to adequately fund the plans before they were terminated. The combined effect of these factors was a sharp increase in the unfunded liabilities of the terminating plans. According to annual reports (Annual Return/Report of Employee Benefit Plan, Form 5500) submitted by Bethlehem Steel Corporation, for example, in the 7 years from 1992 to 1999, the Bethlehem Steel pension plan went from 86 percent funded to 97 percent funded. (See fig. 6.) From 1999 to plan termination in December 2002, however, plan funding fell to 45</p>

percent as assets decreased and liabilities increased, and sponsor contributions were not sufficient to offset the changes.

Figure 6: Assets, Liabilities, and Funded Status of the Bethlehem Steel Corporation Pension Plan, 1992-2002

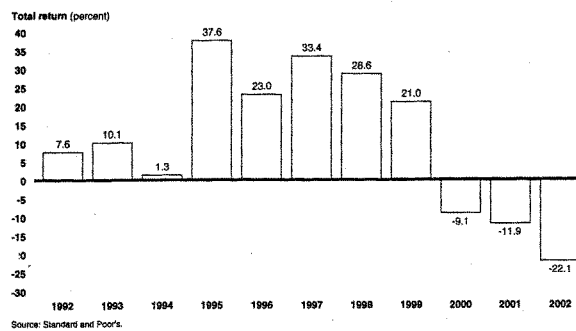


Note: Assets and liabilities for 1992 through 2001 are as of the beginning of the plan year. During that period, the interest rate used by Bethlehem Steel to value current liabilities decreased from 9.26 percent to 6.21 percent. Assets and liabilities for 2002 are PBGC estimates at termination in December 2002. Termination liabilities were valued using a rate of 5 percent.

A decline in the stock market, which began in 2000, was a major cause of the decline in plan asset values, and the associated increase in the degree that plans were underfunded at termination. For example, while total returns for stocks in the Standard and Poor's 500 index (S&P 500) exceeded 20 percent for each year from 1995 through 1999, they were negative starting in 2000, with negative returns reaching 22.1 percent in 2002. (See fig. 7.) Surveys of plan investments by Greenwich Associates

indicated that defined-benefit plans in general had about 62.8 percent of their assets invested in U.S. and international stocks in 1999.²⁹

Figure 7: Total Return on Stocks in the S&P 500 Index, 1992-2002



A stock market decline as severe as the one experienced from 2000 through 2002 can have a devastating effect on the funding of plans that had invested heavily in stocks. For example, according to a survey,³⁰ the Bethlehem Steel defined-benefit plan had about 73 percent of its assets (about \$4.3 billion of \$6.1 billion) invested in domestic and foreign stocks on September 30, 2000. One year later, assets had decreased \$1.5 billion, or 25 percent, and when the plan was terminated in December 2002, its assets had been reduced another 23 percent to about \$3.5 billion—far less than needed to finance an estimated \$7.2 billion in PBGC-guaranteed liabilities.³¹ Over that same general period, stocks in the S&P 500 had a negative return of 38 percent.

²⁹2002 U.S. Investment Management Study, Greenwich Associates, Greenwich, Conn.

³⁰Pensions & Investments, vol. 29, Issue 2 (Chicago: Jan. 22, 2001).

³¹According to the survey, the Bethlehem Steel Corporation pension plan made benefit payments of \$587 million between Sept. 30, 2000, and Sept. 30, 2001. Pensions and Investments, www.pionline.com/pension/pension.cfm (downloaded on June 13, 2003).

In addition to the possible effect of the stock market's decline, a drop in interest rates likely had a negative effect on plan funding levels by increasing plan termination costs. Lower interest rates increase plan termination liabilities by increasing the present value of future benefit payments, which in turn increases the purchase price of group annuity contracts used to terminate defined-benefit pension plans.³² For example, a PBGC analysis indicates that a drop in interest rates of 1 percentage point, from 6 percent to 5 percent, increased the termination liabilities of the Bethlehem Steel pension plan by about 9 percent, which indicates the cost of terminating the plan through the purchase of a group annuity contract would also have increased.³³

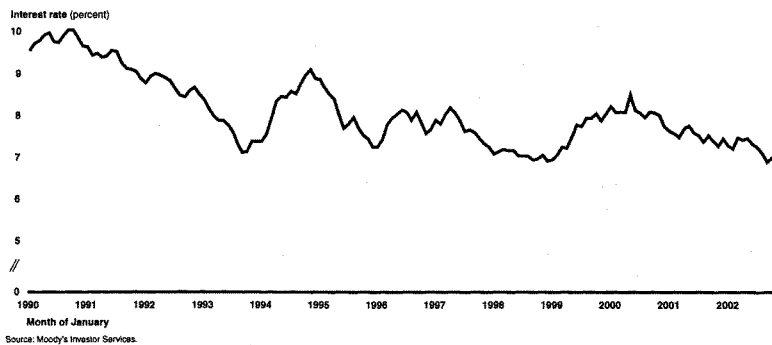
Relevant interest rates may have declined 3 percentage points or more since 1990.³⁴ For example, interest rates on long-term high-quality corporate bonds approached 10 percent at the start of the 1990s, but were below 7 percent at the end of 2002. (See fig. 8.)

³²Present value calculations reflect the time value of money: a dollar in the future is worth less than a dollar today because the dollar today can be invested and earn interest. The calculation requires an assumption about the interest rate, which reflects how much could be earned from investing today's dollars. Assuming a lower interest rate increases the present value of future payments.

³³The magnitude of an increase or decrease in plan liabilities associated with a given change in discount rates would depend on the demographic and other characteristics of each plan.

³⁴To terminate a defined-benefit pension plan without submitting a claim to PBGC, the plan sponsor determines the benefits that have been earned by each participant up to the time of plan termination and purchases a single-premium group annuity contract from an insurance company, under which the insurance company guarantees to pay the accrued benefits when they are due. Interest rates on long-term, high-quality fixed-income securities are an important factor in pricing group annuity contracts because insurance companies tend to invest premiums in such securities to finance annuity payments. Other factors that would have affected group annuity prices include changes in insurance company assumptions about mortality rates and administrative costs.

Figure 8: Interest Rates on Long-Term High-Quality Corporate Bonds, 1990-2002



Minimum Funding Rules and Variable-Rate Premiums Did Not Prevent Plans from Being Severely Underfunded

IRC minimum funding rules and ERISA variable rate premiums, which are designed to ensure plan sponsors adequately fund their plans, did not have the desired effect for the terminated plans that were added to the single-employer program in 2002. The amount of contributions required under IRC minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years.³⁵ Also, the rules require the sponsor to make an additional contribution if the plan is underfunded to the extent defined in the law. However, plan funding is measured using current liabilities, which a PBGC analysis indicates have been typically less than termination liabilities.³⁶ Additionally, plans can earn funding credits, which can be used to offset minimum funding contributions in later years, by contributing more than required according to minimum

³⁵Minimum funding rules permit certain plan liabilities, such as past service liabilities, to be amortized over specified time periods. See 26 U.S.C. 412(b)(2)(B). Past service liabilities occur when benefits are granted for service before the plan was set up or when benefit increases after the set up date are made retroactive.

³⁶For the analysis, PBGC used termination liabilities reported to it under 29 C.F.R. sec 4010.

funding rules. Therefore, sponsors of underfunded plans may avoid or reduce minimum funding contributions to the extent their plan has a credit balance in the account, referred to as the funding standard account, used by plans to track minimum funding contributions.³⁷

While minimum funding rules may encourage sponsors to better fund their plans, the rules require sponsors to assess plan funding using current liabilities, which a PBGC analysis indicates have been typically less than termination liabilities. Current and termination liabilities differ because the assumptions used to calculate them differ. For example, some plan participants may retire earlier if a plan is terminated than they would if the plan continues operations, and lowering the assumed retirement age generally increases plan liabilities, especially if early retirement benefits are subsidized. With respect to two of the terminated underfunded pension plans that we examine, for example, a PBGC analysis indicates:

- The retirement age assumption for the Anchor Glass pension plan on an ongoing plan basis was 65 for separated-vested participants. However, the retirement age assumption appropriate for those participants on a termination basis was 58—a decrease of 7 years. According to PBGC, changing retirement age assumptions for all participants, including separated-vested participants, resulted in a net increase in plan liabilities of about 4.6 percent.
- The retirement age assumption for the Bethlehem Steel pension plan on an ongoing plan basis was 62 for those active participants eligible for unreduced benefits after 30 years of service. On the other hand, the retirement age assumption for them on a plan termination basis was 55—the earliest retirement age. According to PBGC, decreasing the assumed retirement age from 62 to 55 approximately doubled the liability for those participants.

Other aspects of minimum funding rules may limit their ability to affect the funding of certain plans as their sponsors approach bankruptcy. According to its annual reports, for example, Bethlehem Steel contributed about \$3.0 billion to its pension plan for plan years 1986 through 1996. According to the reports, the plan had a credit balance of over \$800 million at the end of plan year 1996. Starting in 1997, Bethlehem Steel reduced its contributions to the plan and, according to annual reports, contributed only about \$71.3

³⁷See 26 U.S.C. 412(b).

million for plan years 1997 through 2001. The plan's 2001 actuarial report indicates that Bethlehem Steel's minimum required contribution for the plan year ending December 31, 2001, would have been \$270 million in the absence of a credit balance; however, the opening credit balance in the plan's funding standard account as of January 1, 2001, was \$711 million. Therefore, Bethlehem Steel was not required to make any contributions during the year.

Other IRC funding rules may have prevented some sponsors from making contributions to plans that in 2002 were terminated at a loss to the single-employer program. For example, on January 1, 2000, the Polaroid pension plan's assets were about \$1.3 billion compared to accrued liabilities of about \$1.1 billion—the plan was more than 100 percent funded. The plan's actuarial report for that year indicates that the plan sponsor was precluded by the IRC funding rules from making a tax-deductible contribution to the plan.³⁸ In July 2002, PBGC terminated the Polaroid pension plan, and the single-employer program assumed responsibility for \$321.8 million in unfunded PBGC-guaranteed liabilities for the plan. The plan was about 67 percent funded, with assets of about \$657 million to pay estimated PBGC-guaranteed liabilities of about \$979 million.

Another ERISA provision, concerning the payment of variable-rate premiums, is also designed to encourage employers to better fund their plans. As with minimum funding rules, the variable-rate premium did not provide sufficient incentives for the plan sponsors that we reviewed to make the contributions necessary to adequately fund their plans. None of the three underfunded plans that we reviewed, which became losses to the single-employer program in 2002 and 2003, paid a variable-rate premium in the 2001 plan year. Plans are exempt from the variable-rate premium if they are at the full-funding limit in the year preceding the premium payment year, in this case 2000, after applying any contributions and credit balances in the funding standard account. Each of these four plans met this criterion.

³⁸See 26 U.S.C. 404(a)(1) and 26 U.S.C. 412(c)(7). The sponsor might have been able to make a contribution to the plan had it selected a lower interest rate for valuing current liabilities. Polaroid used the highest interest rate permitted by law for its calculations.

PBGC Faces Long-Term Financial Risks from a Potential Imbalance of Assets and Liabilities

Two primary risks threaten the long-term financial viability of the single-employer program. The greater risk concerns the program's liabilities: large losses, due to bankrupt firms with severely underfunded pension plans, could continue or accelerate. This could occur if returns on investment remain poor, interest rates stay low, and economic problems persist. More troubling for liabilities is the possibility that structural weaknesses in industries with large underfunded plans, including those greatly affected by increasing global competition, combined with the general shift toward defined-contribution pension plans, could jeopardize the long-term viability of the defined-benefit system. On the asset side, PBGC also faces the risk that it may not receive sufficient revenue from premium payments and investments to offset the losses experienced by the single-employer program in 2002 or that this program may experience in the future. This could happen if program participation falls or if PBGC earns a return on its assets below the rate it uses to value its liabilities.

Several Factors Affect the Degree to Which Plans Are Underfunded and the Likelihood That Plan Sponsors Will Go Bankrupt

Plan terminations affect the single-employer program's financial condition because PBGC takes responsibility for paying benefits to participants of underfunded terminated plans. Several factors would increase the likelihood that sponsoring firms will go bankrupt, and therefore will need to terminate their pension plans, and the likelihood that those plans will be underfunded at termination. Among these are poor investment returns, low interest rates, and continued weakness in the national economy and or specific sectors. Particularly troubling may be structural weaknesses in certain industries with large underfunded defined-benefit plans.

Poor investment returns from a decline in the stock market can affect the funding of pension plans. To the extent that pension plans invest in stocks, the decline in the stock market will increase the chance that plans will be underfunded should they terminate. A Greenwich Associates survey of defined-benefit plan investments indicates that 59.4 percent of plan assets were invested in stocks in 2002.²⁰ Clearly, the future direction of the stock market is very difficult to forecast. From the end of 1999 through the end of 2002, total cumulative returns in the stock market, as measured by the S&P 500, were negative 37.6 percent. In 2003, the S&P 500 has partially recovered those losses, with total returns (from a lower starting point) of 14.7 percent through the end of September. From January 1975, the beginning of the first year following the passage of ERISA, through

²⁰2002 U.S. Investment Management Study, Greenwich Associates, Greenwich, Conn.

September 2003, the average annual compounded nominal return on the S&P 500 equaled 13.5 percent.

A decline in asset values can be particularly problematic for plans if interest rates remain low or fall, which raises plan liabilities, all else equal. The highest allowable discount rate for calculating current plan liabilities, based on the 30-year U.S. Treasury bond rate, has been no higher than 7.1 percent since April, 1998, lower than any previous point during the 1990s.⁴⁰ Falling interest rates raise the price of group annuities that a terminating plan must purchase to cover its promised benefits and increase the likelihood that a terminating plan will not have sufficient assets to make such a purchase.⁴¹ An increase in liabilities due to falling interest rates also means that companies may be required under the minimum funding rules to increase contributions to their plans. This can create financial strain and increase the chances of the firm going bankrupt, thus increasing the risk that PBGC will have to take over an underfunded plan.

Economic weakness can also lead to greater underfunding of plans and to a greater risk that underfunded plans will terminate. For many firms, slow or declining economic growth causes revenues to decline, which makes contributions to pension plans more difficult. Economic sluggishness also raises the likelihood that firms sponsoring pension plans will go bankrupt. Three of the last five annual increases in bankruptcies coincided with recessions, and the record economic expansion of the 1990s is associated with a substantial decline in bankruptcies. Annual plan terminations resulting in losses to the single-employer program rose from 83 in 1989 to 175 in 1991, and, after declining to 65 in 2000, the number reached 93 in 2001.⁴²

⁴⁰The U.S. Treasury stopped publishing a 30-year Treasury bond rate in February 2002, but the Internal Revenue Service publishes rates for pension calculations based on rates for the last-issued bonds in February 2001. Interest rates to calculate plan liabilities must be within a "permissible range" around a 4-year weighted average of 30-year Treasury bond rates; the permissible range for plan years beginning in 2002 and 2003 was 90 to 120 percent of this 4-year weighted average.

⁴¹A potentially offsetting effect of falling interest rates is the possible increased return on fixed-income assets that plans, or PBGC, hold. When interest rates fall, the value of existing fixed-income securities with time left to maturity rises.

⁴²The last three recessions on record in the United States occurred during 1981, 1990-91, and 2001. (See www.bea.gov/bea/dn/gdpchg.xls.)

Weakness in certain industries, particularly the airline and automotive industries, may threaten the viability of the single-employer program. Because PBGC has already absorbed most of the pension plans of steel companies, it is the airline industry, with \$26 billion of total pension underfunding, and the automotive sector, with over \$60 billion in underfunding, that currently represent PBGC's greatest future financial risks. In recent years, profit pressures within the U.S. airline industry have been amplified by severe price competition, recession, terrorism, the war in Iraq, and the outbreak of Severe Acute Respiratory Syndrome (SARS), creating recent bankruptcies and uncertainty for the future financial health of the industry. As one pension expert noted, a potentially exacerbating risk in weak industries is the cumulative effect of bankruptcy; if a critical mass of firms go bankrupt and terminate their underfunded pension plans, others, in order to remain competitive, may also declare bankruptcy to avoid the cost of funding their plans.

Because the financial condition of both firms and their pension plans can eventually affect PBGC's financial condition, PBGC tries to determine how many firms are at risk of terminating their pension plans and the total amount of unfunded vested benefits. According to PBGC's fiscal year 2002 estimates, the agency is at potential risk of taking over \$35 billion in unfunded vested benefits from plans that are sponsored by financially weak companies and could terminate.⁴³ Almost one-third of these unfunded benefits, about \$11.4 billion, are in the airline industry. Additionally, PBGC estimates that it could become responsible for over \$15 billion in shutdown benefits in PBGC-insured plans.

PBGC uses a model called the Pension Insurance Modeling System (PIMS) to simulate the flow of claims to the single-employer program and to project its potential financial condition over a 10-year period. This model produces a very wide range of possible outcomes for PBGC's future net financial position.⁴⁴

⁴³This estimate comprises "reasonably possible" terminations, which include plans sponsored by companies with credit quality below investment grade that may terminate, though likely not by year-end. Plan participants have a nonforfeitable right to vested benefits, as opposed to nonvested benefits, for which participants have not yet completed qualification requirements.

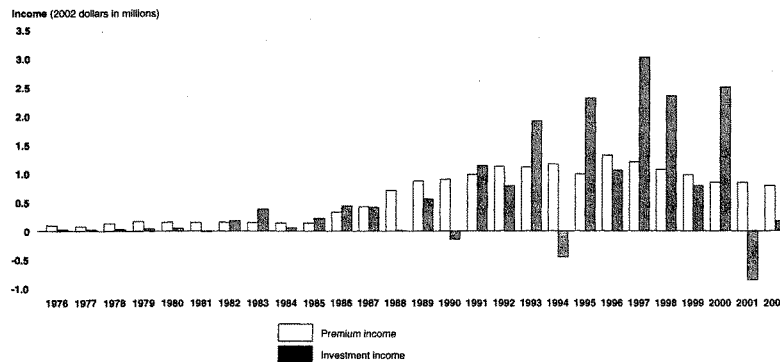
⁴⁴PBGC began using PIMS to project its future financial condition in 1998. Prior to this, PBGC provided low-, medium-, and high-loss forecasts, which were extrapolations from the agency's claims experience and the economic conditions of the previous 2 decades.

Revenue from Premiums and Investments May Not Offset Program's Current Deficit or Possible Future Losses

To be viable in the long term, the single-employer program must receive sufficient income from premiums and investments to offset losses due to terminating underfunded plans. A number of factors could cause the program's revenues to fall short of this goal or decline outright. For example, fixed-rate premiums would decline if the number of participants covered by the program decreases, which may happen if plans leave the system and are not replaced. Additionally, the program's financial condition would deteriorate to the extent investment returns fall below the assumed interest rate used to value liabilities.

Annual PBGC income from premiums and investments averaged \$1.3 billion from 1976 to 2002, in 2002 dollars, and \$2 billion since 1988, when variable-rate premiums were introduced. Since 1988, investment income has on average equaled premium income, but has varied more than premium income, including 3 years in which investment income fell below zero. (See fig. 9.) In 2001, total premium and investment was negative and in 2002 equaled approximately \$1 billion.

Figure 9: PBGC Premium and Investment Income, 1976-2002



Source: PBGC annual financial reports.

Note: We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

Premium revenue for PBGC would likely decline if the total number of plans and participants terminating their defined-benefit plans exceeded the new plans and participants joining the system. This decline in participation would mean a decline in PBGC's flat-rate premiums. If more plans become underfunded, this could possibly raise the revenue PBGC receives from variable-rate premiums, but would also be likely to raise the overall risk of plans terminating with unfunded liabilities. Premium income, in 2002 dollars, has fallen every year since 1996, even though the Congress lifted the cap on variable-rate premiums in that year.

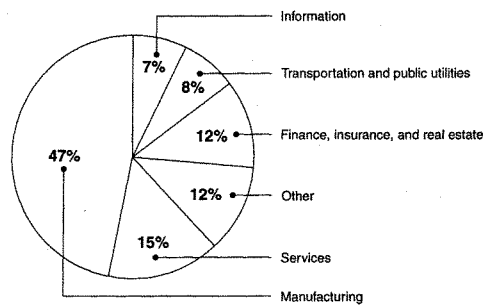
The decline in the number of plans PBGC insures may cast doubt on its ability to increase premium income in the future. The number of PBGC-insured plans has decreased steadily from approximately 110,000 in 1987 to around 30,000 in 2002.⁴⁵ While the number of total participants in

⁴⁵In contrast, defined-contribution plans have grown significantly over a similar period—from 462,000 plans in 1985 to 674,000 plans in 1998.

PBGC-insured single-employer plans has grown approximately 25 percent since 1980, the percentage of participants who are active workers has declined from 78 percent in 1980 to 53 percent in 2000. Manufacturing, a sector with virtually no job growth in the last half-century, accounted for almost half of PBGC's single-employer program participants in 2001, suggesting that the program needs to rely on other sectors for any growth in premium income. (See fig 10.) In addition, a growing percentage of plans have recently become hybrid plans, such as cash-balance plans that incorporate characteristics of both defined-contribution and defined-benefit plans. Hybrid plans are more likely than traditional defined-benefit plans to offer participants the option of taking benefits as a lump-sum distribution. If the proliferation of hybrid plans increases the number of participants taking lump sums instead of retirement annuities, over time this would reduce the number of plan participants, thus potentially reducing PBGC's flat-rate premium revenue.⁴⁹ Unless something reverses these trends, PBGC may have a shrinking plan and participant base to support the program in the future and that base may be concentrated in certain, potentially more vulnerable industries.

⁴⁹If a plan sponsor purchases an annuity for a retiree from an insurance company to pay benefits, this would also remove the retiree from the participant pool, which would have the same effect on flat-rate premiums.

Figure 10: Distribution of PBGC-Insured Participants by Industry, 2001



Source: PBGC.

Note: Percentages do not sum to 100 due to rounding.

Even more problematic than the possibility of falling premium income may be that PBGC's premium structure does not reflect many of the risks that affect the probability that a plan will terminate and impose a loss on PBGC. While PBGC charges plan sponsors a variable-rate premium based on the plan's level of underfunding, premiums do not consider other relevant risk factors, such as the economic strength of the sponsor, plan asset investment strategies, the plan's benefit structure, or the plans demographic profile. Because these affect the risk of PBGC having to take over an underfunded pension plan, it is possible that PBGC's premiums will not adequately and equitably protect the agency against future losses. The recent terminations of Bethlehem Steel, Anchor Glass, and Polaroid, plans that paid no variable-rate premiums shortly before terminating with large underfunded balances, lend some evidence to this possibility. Sponsors also pay flat-rate premiums in addition to variable-rate premiums, but these reflect only the number of plan participants and not other risk factors that affect PBGC's potential exposure to losses. Full-funding limitations may exacerbate the risk of underfunded terminations by preventing firms from contributing to their plans during strong economic times when asset values are high and firms are in the best financial position to make contributions.

It may also be difficult for PBGC to diversify its pool of insured plans among strong and weak sponsors and plans. In addition to facing firm-specific risk that an individual underfunded plan may terminate, PBGC faces market risk that a poor economy may lead to widespread underfunded terminations during the same period, which potentially could cause very large losses for PBGC. Similarly, PBGC may face risk from insuring plans concentrated in vulnerable industries that may suffer bankruptcies over a short time period, as has happened recently in the steel and airline industries. One study estimates that the overall premiums collected by PBGC amount to about 50 percent of what a private insurer would charge because its premiums do not account for this market risk.⁴⁷

The net financial position of the single-employer program also depends heavily on the long-term rate of return that PBGC achieves from the investment of the program's assets. All else equal, PBGC's net financial condition would improve if its total net return on invested assets exceeded the discount rate it used to value its liabilities. For example, between 1993 and 2000 the financial position of the single-employer program benefited from higher rates of return on its invested assets and its financial condition improved. However, if the rate of return on assets falls below the discount rate, PBGC's finances would worsen, all else equal. As of September 30, 2002, PBGC had approximately 65 percent of its single-employer program investments in U.S. government securities and approximately 30 percent in equities. The high percentage of assets invested in Treasury securities, which typically earn low yields because they are considered to be relatively "risk-free" assets, may limit the total return on PBGC's portfolio.⁴⁸ Additionally, PBGC bases its discount rate on surveys of insurance company group annuity prices, and because PBGC invests differently than do insurance companies, we might expect some divergence between the discount rate and PBGC's rate of return on assets. PBGC's return on total invested funds was 2.1 percent for the year ending September 30, 2002, and 5.8 percent for the 5-year period ending on that date. For fiscal year 2002, PBGC used an annual discount rate of 5.70 percent to determine the present value of future benefit payments through 2027 and a rate of 4.75 percent for payments made in the remaining years.

⁴⁷Boyce, Steven, and Richard A. Ippolito, "The Cost of Pension Insurance," *The Journal of Risk and Insurance* (2002) vol. 69, No.2, p. 121-170.

⁴⁸The return on fixed-income assets sold before maturity may also be affected by capital gains (or losses). The price of a bond moves in the opposite direction as interest rates, and so if interest rates fall, bondholders may reap capital gains.

The magnitude and uncertainty of these long-term financial risks pose particular challenges for the PBGC's single-employer insurance program and potentially for the federal budget. In 1990, we began a special effort to review and report on the federal program areas we considered high risk because they were especially vulnerable to waste, fraud, abuse, and mismanagement. In the past, we considered PBGC to be on our high-risk list because of concerns about the program's viability and about management deficiencies that hindered that agency's ability to effectively assess and monitor its financial condition. The current challenges to PBGC's single-employer insurance program concern immediate as well as long-term financial difficulties, which are more structural weaknesses rather than operational or internal control deficiencies. Nevertheless, because of serious risks to the program's viability, we have placed the PBGC single-employer insurance program on our high-risk list.

Several Reforms Might Reduce The Risks To The Program's Financial Viability

Although some pension professionals have suggested a "wait and see" approach, betting that brighter economic conditions improving PBGC's future financial condition are imminent, agency officials and other pension professionals have suggested taking a more prudent, proactive approach, identifying a variety of options that could address the challenges facing PBGC's single-employer program. In our view, several types of reforms might be considered to reduce the risks to the single-employer program's long-term financial viability. These reforms could be made to

- strengthen funding rules applicable to poorly funded plans;
- modify program guarantees;
- restructure premiums; and
- improve the availability of information about plan investments, termination funding, and program guarantees.

Several variations exist within these options and each has advantages and disadvantages. In any event, any changes adopted to address the challenge facing PBGC should provide a means to hold sponsors accountable for adequately funding their plans, provide plan sponsors with incentives to increase plan funding, and improve the transparency of the plan's financial information.

**Strengthening Plan
Funding Rules Might
Reduce Program Risks**

Funding rules could be strengthened to increase minimum contributions to underfunded plans and to allow additional contributions to fully funded plans.⁴⁹ This approach would improve plan funding over time, while limiting the losses PBGC would incur when a plan is terminated. However, even if funding rules were to be strengthened immediately, it could take years for the change to have a meaningful effect on PBGC's financial condition. In addition, such a change would require some sponsors to allocate additional resources to their pension plans, which may cause the plan sponsor of an underfunded plan to provide less generous wages or benefits than would otherwise be provided. The IRC could be amended to:

- **Base additional funding requirement and maximum tax-deductible contributions on plan termination liabilities, rather than current liabilities.** Since plan termination liabilities typically exceed current liabilities, such a change would likely improve plan funding and therefore reduce potential claims against PBGC. One problem with this approach is the difficulty plan sponsors would have determining the appropriate interest rate to use in valuing termination liabilities. As we reported,

⁴⁹If the Congress chooses to replace the 30-year Treasury rate used to calculate pension plan liabilities, the level of the interest rate selected can also affect plan funding. For example, if a rate that is higher than the current rate is selected, plan liabilities would appear better funded, thereby decreasing minimum and maximum employer contributions. In addition, some plans would reach full-funding limitations and avoid having to pay variable-rate premiums. Therefore, PBGC would receive less revenue. Conversely, a lower rate would likely improve PBGC's financial condition. In 1987, when the 30-year Treasury rate was adopted for use in certain pension calculations, the Congress intended that the interest rate used for current liability calculations would, within certain parameters, reflect the price an insurance company would charge to take responsibility for the plans pension payments. However, in the late 1990s, when fewer 30-year Treasury bonds were issued and economic conditions increased demand for the bonds, the 30-year Treasury rate diverged from other long-term interest rates, an indication that it also may have diverged from group annuity purchase rates. In 2001, Treasury stopped issuing these bonds altogether, and in March 2002, the Congress enacted temporary measures to alleviate employer concerns that low interest rates on the remaining 30-year Treasury bonds were affecting the reasonableness of the interest rate for employer pension calculations. Selecting a replacement rate is difficult because little information exists on which to base the selection. Other than the survey conducted for PBGC, no mechanism exists to collect information on actual group annuity purchase rates. Compared to other alternatives, the PBGC interest rate factors may have the most direct connection to the group annuity market, but PBGC factors are less transparent than market-determined alternatives. Long-term market rates may track changes in group annuity rates over time, but their proximity to group annuity rates is also uncertain. For example, an interest rate based on a long-term market rate, such as corporate bond indexes, may need to be adjusted downward to better reflect the level of group annuity purchase rates. However, as we stated in our report earlier this year, establishing a process for regulatory adjustments to any rate selected may make it more suitable for pension plan liability calculations. See GAO-03-313.

selecting an appropriate interest rate for termination liability calculations is difficult because little information exists on which to base the selection.⁵⁰

- **Raise threshold for additional funding requirement.** The IRC requires sponsors to make additional contributions under two circumstances: (1) if the value of plan assets is less than 80 percent of its current liability or (2) if the value of plan assets is less than 90 percent of its current liability, depending on plan funding levels for the previous 3 years. Raising the threshold would require more sponsors of underfunded plans to make the additional contributions.
- **Limit the use of credit balances.** For sponsors who make contributions in any given year that exceed the minimum required contribution, the excess plus interest is credited against future required contributions. Limiting the use of credit balances to offset contribution requirements might also prevent sponsors of significantly underfunded plans from avoiding contributions. Such limitations might also be applied based on the plan sponsor's financial condition. For example, sponsors with poor cash flow or low credit ratings could be restricted from using their credit balances to reduce their contributions.
- **Limit lump-sum distributions.** Defined benefit pension plans may offer participants the option of receiving their benefit in a lump-sum payment. Allowing participants to take lump-sum distributions from severely underfunded plans, especially those sponsored by financially weak companies, allows the first participants who request a distribution to drain plan assets, which might result in the remaining participants receiving reduced payments from PBGC if the plan terminates. However, the payment of lump sums by underfunded plans may not directly increase losses to the single employer program because lump sums reduce plan liabilities as well as plan assets.
- **Raise the level of tax-deductible contributions.** The IRC and ERISA restrict tax-deductible contributions to prevent plan sponsors from contributing more to their plan than is necessary to cover accrued future benefits.⁵¹ Raising these limitations might result in pension plans being

⁵⁰GAO-03-313.

⁵¹Employers are generally subject to an excise tax for failure to make required contributions or for making contributions in excess of the greater of the maximum deductible amount or the ERISA full-funding limit.

better funded, decreasing the likelihood that they will be underfunded should they terminate.⁶²

**Modifying Program
Guarantee Would Decrease
Plan Underfunding**

Modifying certain guaranteed benefits could decrease losses incurred by PBGC from underfunded plans. This approach could preserve plan assets by preventing additional losses that PBGC would incur when a plan is terminated. However, participants would lose benefits provided by some plan sponsors. ERISA could be amended to:

- **Phase-in the guarantee of shutdown benefits.** PBGC is concerned about its exposure to the level of shutdown benefits that it guarantees. Shutdown benefits provide additional benefits, such as significant early retirement benefit subsidies to participants affected by a plant closing or a permanent layoff. Such benefits are primarily found in the pension plans of large unionized companies in the auto, steel, and tire industries. In general, shutdown benefits cannot be adequately funded before a shutdown occurs. Phasing in guarantees from the date of the applicable shutdown could decrease the losses incurred by PBGC from underfunded plans.⁶³ However, modifying these benefits would reduce the early retirement benefits for participants who are in plans with such provisions and are affected by a plant closing or a permanent layoff. Dislocated workers, particularly in manufacturing, may suffer additional losses from lengthy periods of unemployment or from finding reemployment only at much lower wages.
- **Expand restrictions on unfunded benefit increases.** Currently, plan sponsors must meet certain conditions before increasing the benefits of plans that are less than 60 percent funded.⁶⁴ Increasing this threshold, or restricting benefit increases when plans reach the threshold, could decrease the losses incurred by PBGC from underfunded plans. Plan

⁶²For example, one way to do this would be to allow deductions within a corridor of up to 130 percent of current liabilities. Gebhardtshauer, Ron. American Academy of Actuaries testimony before the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, U.S. House of Representatives, Hearing on *Strengthening Pension Security: Examining the Health and Future of Defined Benefit Pension Plans*. (Washington, D.C.: June 4, 2003), 9.

⁶³Currently, some measures exist to limit the losses incurred by PBGC from newly terminated plans. PBGC is responsible for only a portion of all benefit increases that the sponsor adds in the 5 years leading up to termination.

⁶⁴IRC provides generally that a plan less than 60 percent funded on a current liability basis may not increase benefits without either immediately funding the increase or providing security. See 26 U.S.C. 401(a)(29).

	<p>sponsors have said that the disadvantage of such changes is that they would limit an employer's flexibility with regard to setting compensation, making it more difficult to respond to labor market developments. For example, a plan sponsor might prefer to offer participants increased pension payments or shutdown benefits instead of offering increased wages because pension benefits can be deferred—providing time for the plan sponsor to improve its financial condition—while wage increases have an immediate effect on the plan sponsor's financial condition.</p>
Restructuring The Program's Premium Structure Might Improve Its Financial Viability	<p>PBGC's premium rates could be increased or restructured to improve PBGC's financial condition. Changing premiums could increase PBGC's revenue or provide an incentive for plan sponsors to better fund their plans. However, premium changes that are not based on the degree of risk posed by different plans may force financially healthy companies out of the defined-benefit system and discourage other plan sponsors from entering the system. Various actions could be taken to reduce guaranteed benefits. ERISA could be amended to:</p> <ul style="list-style-type: none">• Increase or restructure variable-rate premium. The current variable-rate premium of \$9 per \$1,000 of unfunded liability could be increased. The rate could also be adjusted so that plans with less adequate funding pay a higher rate. Premium rates could also be restructured based on the degree of risk posed by different plans, which could be assessed by considering the financial strength and prospects of the plan's sponsor, the risk of the plan's investment portfolio, participant demographics, and the plan's benefit structure—including plans that have lump-sum,⁵⁶ shutdown benefit, and floor-offset provisions.⁵⁸ One advantage of a rate increase or restructuring is that it might improve accountability by providing for a more direct relationship between the amount of premium paid and the risk of underfunding. A disadvantage is that it could further burden already struggling plan sponsors at a time when they can least afford it, or it could reduce plan assets, increasing the likelihood that underfunded plans will terminate. A program with premiums that are more risk-based could also be more challenging for PBGC to administer.

⁵⁶For example, a plan that allows a lump-sum option—as is often found in a cash-balance and other hybrid plan—may pose a different level of risk to PBGC than a plan that does not.

⁵⁸Under the floor-offset arrangement, the benefit computed under the final pay formula is "offset" by the benefit amount that the account of another plan, such as an Employee Stock Ownership Plan, could provide.

	<ul style="list-style-type: none">• Increase fixed-rate premium. The current fixed rate of \$19 per participant annually could be increased. Since the inception of PBGC, this rate has been raised four times, most recently in 1991 when it was raised from \$16 to \$19. Such increases generally raise premium income for PBGC, but the current fixed-rate premium has not reflected the changes in inflation since 1991. By indexing the rate to the consumer price index, changes to the premium would be consistent with inflation. However, any increases in the fixed-rate premium would affect all plans regardless of the adequacy of their funding.
Increasing Transparency of Plan Information Might Encourage Sponsors to Better Fund Plans, Reducing Program Risks	<p>Improving the availability of information to plan participants and others about plan investments, termination funding status, and PBGC guarantees may give plan sponsors additional incentives to better fund their plans, making participants better able to plan for their retirement. ERISA could be amended to:</p> <ul style="list-style-type: none">• Disclose information on plan investments. While some asset allocation information is reported by plans in form 5500 filings with the IRS, some plan investments may be made through common and collective trusts, master trusts, and registered investment companies, which make it difficult or impossible for participants and others to determine the asset classes—such as equity or fixed-income investments—for many plan investments. Improving the availability of plan asset allocation information may give plan sponsors an incentive to increase funding of underfunded plans or limit risky investments. Information provided to participants could also disclose how much of plan assets are invested in the sponsor's own securities. This would be of concern because should the sponsor becomes bankrupt, the value of the securities could be expected to drop significantly, reducing plan funding. Although this information is currently provided in the plan's form 5500, it is not readily accessible to participants. Additionally, if the defined-benefit plan has a floor-offset arrangement and its benefits are contingent on the investment performance of a defined-contribution plan, then information provided to participants could also disclose how much of that defined-contribution plan's assets are invested in the sponsor's own securities.• Disclose plan termination funding status. Under current law, sponsors are required to report a plan's current liability for funding purposes, which often can be lower than termination liability. In addition, only participants in plans below a certain funding threshold receive annual notices of the

funding status of their plans.⁶⁷ As a result, many plan participants, including participants of the Bethlehem Steel pension plan, did not receive such notifications in the years immediately preceding the termination of their plans. Expanding the circumstances under which sponsors must notify participants of plan underfunding might give sponsors an additional incentive to increase plan funding and would enable more participants to better plan their retirement.

- **Disclose benefit guarantees to additional participants.** As with the disclosure of plan funding status, only participants of plans below the funding threshold receive notices on the level of program guarantees should their plan terminate. Termination of a severely underfunded plan can significantly reduce the benefits participants receive. For example, 59-year old pilots were expecting annual benefits of \$110,000 per year on average when the US Airways plan was terminated in 2003, while the maximum PBGC-guaranteed benefit at age 60 is \$28,600 per year.⁶⁸ Expanding the circumstances under which plan sponsors must notify participants of PBGC guarantees may enable more participants to better plan for their retirement.

Conclusion

The current financial challenges facing PBGC and the array of policy options to address those challenges are more appropriately viewed within the context of the agency's overall mission. In 1974, ERISA placed three important charges on PBGC: first, protect the pension benefits so essential to the retirement security of hard working Americans; second, minimize the pension insurance premiums and other costs of carrying out the agency's obligations; and finally, foster the health of the private defined-

⁶⁷The ERISA requirement that plan sponsors notify participants and beneficiaries of the plan's funding status and limits on the PBGC guarantee currently goes into effect when plans are required to pay variable-rate premiums and meet certain other requirements. See 29 U.S.C. 1311 and 29 C.F.R. 4011.3.

⁶⁸However, the actual benefit paid by PBGC depends on a number of factors and may exceed the maximum guaranteed benefit. For example, PBGC expects that the average annual benefit paid to U.S. Airways pilots who are 59 years of age with 29 years of service will be about \$85,000, including nonguaranteed amounts. PBGC said that many US Airways pilots will receive more than the \$28,600 maximum limit because, according to priorities established under ERISA, pension plan participants may receive benefits in excess of the guaranteed amounts if there are enough assets or recoveries from the plan sponsors. For example, a participant who could have retired 3 years prior to plan termination (but did not) may be eligible to receive both guaranteed and nonguaranteed amounts. PBGC letter in response to follow-up questions from the Committee on Finance, U. S. Senate (Washington, D.C.: April 1, 2003).

benefit pension plan system. While addressing one or even two of these goals would be a challenge, it is a far more formidable endeavor to fulfill all three. In any event, any changes adopted to address the challenges facing PBGC should provide plan sponsors with incentives to increase plan funding, improve the transparency of the plan's financial information, and provide a means to hold sponsors accountable for funding their plans adequately. Ultimately, however, for any insurance program, including the single-employer pension insurance program, to be self-financing, there must be a balance between premiums and the program's exposure to losses.

A variety of options are available to the Congress and PBGC to address the short-term vulnerabilities of the single-employer insurance program. Congress will have to weigh carefully the strengths and weaknesses of each option as it crafts the appropriate policy response. However, to understand the program's structural problems, it helps to understand how much the world has changed since the enactment of ERISA. In 1974, the long-term decline that our nation's private defined-benefit pension system has experienced since that time might have been difficult for some to envision. Although there has been some absolute growth in the system since 1980, active workers have comprised a declining percentage of program participants, and defined-benefit plan coverage has declined as a percentage of the national private labor force. The causes of this long-term decline are many and complex and have turned out to be more systemic, more structural in nature, and far more powerful than the resources and bully pulpit that PBGC can bring to bear.

This trend has had important implications for the nature and the magnitude of the risk that PBGC must insure. Since 1987, as employers, both large and small, have exited the system, newer firms have generally chosen other vehicles to help their employees provide for their retirement security. This has left PBGC with a risk pool of employers that is concentrated in sectors of the economy, such as air transportation and automobiles, which have become increasingly vulnerable. As of 2002, almost half of all defined-benefit plan participants were covered by plans offered by firms in manufacturing industries. The secular decline and competitive turmoil already experienced in industries like steel and air transportation could well extend to the other remaining strongholds of defined-benefit plans in the future, weakening the system even further.

Thus, the long-term financial health of PBGC and its ability to protect workers' pensions is inextricably bound to this underlying change in the nature of the risk that it insures, and implicitly to the prospective health of

the defined-benefit system. Options that serve to revitalize the defined benefit system could stabilize PBGC's financial situation, although such options may be effective only over the long term. The more immediate challenge, however, is the fundamental consideration of the manner in which the federal government protects the defined-benefit pensions of workers in this increasingly risky environment. We look forward to working with the Congress on this crucial subject.

Mr. Chairman, members of the committee, that concludes my statement. I'd be happy to answer any questions you may have.

Appendix I: Key Legislative Changes That Affect the Single-Employer Insurance Program

As part of the Employee Retirement and Income Security Act (ERISA) of 1974, the Congress established the Pension Benefit Guaranty Corporation (PBGC) to administer the federal insurance program. Since 1974, the Congress has amended ERISA to improve the financial condition of the insurance program and the funding of single-employer plans (see table 1).

Table 1: Key Legislative Changes to the Single-Employer Insurance Program Since ERISA Was Enacted

Year	Law	Number	Key provisions
1974	ERISA	P.L. 93-406	Created a federal pension insurance program and established a flat-rate premium and minimum and maximum funding rules.
1986	Single-Employer Pension Plan Amendments Act of 1986 enacted as Title XI of the Consolidated Omnibus Budget Reconciliation Act of 1985	P.L. 99-272	Raised the flat-rate premium and established financial distress criteria that sponsoring employers must meet to terminate an underfunded plan.
1987	Pension Protection Act enacted as part of the Omnibus Budget Reconciliation Act of 1987	P.L. 100-203	Increased the flat-rate premium and added a variable-rate premium based on 80 percent of the 30-year Treasury rate. In addition, established a permissible range of 90-110 percent around the weighted average 30-year of the Treasury rate as the basis for current liability calculations, increased the minimum funding standards, and established a full-funding limitation based on 150 percent of current liability.
1994	Retirement Protection Act enacted as part of the Uruguay Rounds Agreements Act, also referred to as the General Agreement on Tariffs and Trade	P.L. 103-465	Raised the basis for variable-rate premium calculation from 80 percent to 85 percent of the 30-year Treasury rate (effective July 1997). Phased out the cap on the variable-rate premium. Strengthened funding requirements by narrowing the permissible range of the allowable interest rates to 90-105 percent of the weighted average 30-year Treasury rate and standardizing mortality assumptions for the current liability calculation. Also, established 90 percent as the minimum full-funding limitation.
2001	The Economic Growth and Tax Relief Reconciliation Act of 2001	P.L. 107-16	Accelerated the phasing out of the 160 percent full-funding limitation and repealed it for plan years beginning in 2004 and thereafter.
2002	The Job Creation and Worker Assistance Act of 2002	P.L. 107-147	Temporarily expanded the permissible range of the statutory interest rates to 90 to 120 percent of the weighted average of the 30-year Treasury rate for current liability calculations and temporarily increased the PBGC variable-rate premium calculations to 100 percent of the 30-year Treasury rate for plan years beginning after December 31, 2001, and before January 1, 2004.

Source: Public Law.

GAO's Mission

The General Accounting Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

**Obtaining Copies of
GAO Reports and
Testimony**

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to e-mail alerts" under the "Order GAO Products" heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
 TDD: (202) 512-2537
 Fax: (202) 512-6061

**To Report Fraud,
Waste, and Abuse in
Federal Programs**
Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

The CHAIRMAN. Barbara, thank you. Before we question you, we will move through all of our panelists. Now let me turn to Steve Kandarian, Executive Director of the Pension Benefit Guarantee Corporation. Steve, thank you for being here morning.

**STATEMENT OF STEVE KANDARIAN, EXECUTIVE DIRECTOR,
PENSION BENEFIT GUARANTEE CORPORATION,
WASHINGTON, DC**

Mr. KANDARIAN. Mr. Chairman, thank you for holding this hearing on the financial health of PBGC and the future of the defined benefit system.

During fiscal year 2002, PBGC single employer insurance program went from a surplus of \$7.7 billion to a deficit of \$3.6 billion, a loss of \$11.3 billion in just one year. Based on our latest unaudited financial report, the deficit has grown to \$8.8 billion as of August 31, 2003.

The continued deterioration of PBGC's financial condition is due to a number of factors, including a decline in interest rates, additional terminations, and new probable claims. In addition, pension underfunding remains at near record levels. At the end of 2000 total underfunding in single employer pension plans was less than \$50 billion. Because of declining interest rates and equity values as of December 31, 2002, just two years later, underfunding exceeded \$400 billion, the largest number ever recorded. Even with recent rises in equity values we estimate the underfunding still exceeds \$350 billion.

The title of this hearing asks whether America's pensions will become the next savings and loan crisis. At the moment, PBGC has sufficient assets in hand to pay benefits for a number of years into the future. But our deficit is the largest in history and has continued to grow. Some have suggested that Congress can afford to address these issues at some future point. We believe there are serious structural issues that require fundamental reform to the defined benefit system now before we reach a crisis point.

To begin to deal with the problem of pension underfunding, the Administration has released an initial set of proposals to more accurately measure pension liabilities, improve disclosure of pension information to workers and investors, and strengthen safeguards against underfunding in troubled plans.

We also recognize that with the bursting of the stock market bubble and return to lower interest rates, companies are having to make much larger contributions to their pension plans. The House and the Senate Finance Committee have approved separate bills that would provide short-term funding relief by allowing plan sponsors to discount pension liabilities at a higher interest rate, an approach broadly consistent with the transitional portion of the administration's proposal over the same timeframe.

However, the Administration strongly opposes any provision that would weaken, suspend, or eliminate the deficit reduction contribution enacted in 1987 to protect workers in underfunded pension plans.

The DRC requires companies with the worst funded plans to pay off their unfunded liabilities over 3 to 7 years, a relatively fast schedule designed to get plans funded before companies fail and

transfer their liabilities to PBGC. A DRC waiver would permit financially weak companies with plans at the greatest risk of terminating to stop making accelerated pension contributions, even though the average funding ratio of these plans is less than 60 percent. PBGC estimates that a 3-year DRC suspension would increase pension underfunding by \$40 billion.

While the DRC can contribute to funding volatility, any modifications should be considered in the context of other reforms that strengthen long-term pension funding. Eliminating the DRC without an effective substitute increases the risk that workers will lose promised benefits and PBGC will suffer additional large losses.

It is also important to put into context the large pension contributions that plans are now required to make. Because of the unprecedented investment returns of the mid to late 1990's, many companies made little or no cash contributions for several years. From 1995 to 1999 total pension contributions averaged only \$26 billion a year in 2002 dollars. In the early 1980's, total contributions averaged \$63 billion a year in 2002 dollars. Over the same period, the amount of pension benefits insured by PBGC more than doubled in real dollars, even as pension contributions were cut by more than half.

It is not reasonable to base funding expectations on the assumption that the stock market gains of the 1990's will repeat themselves. The real rate of return in equities from 1926 through 2002 was 6.9 percent. But from 1983 through 2002 a period that ended with nearly 3 years of steep market declines, real returns were 9.3 percent, more than a third higher.

Current funding requirements are not inconsistent with contribution levels in periods of more normal equity returns, especially given the growth in benefits that has occurred.

Mr. Chairman, the Administration is working on comprehensive reforms that will put pension plans on a predictable steady path to better funding. In the meantime, we urge Congress not to abandon the deficit reduction contribution that requires sponsors of at-risk plans to pay for the promises they make.

Thank you for inviting me to testify. I will be happy to answer any questions.

[The prepared statement of Mr. Kandarian follows:]



**PENSION BENEFIT GUARANTY CORPORATION
OFFICE OF PUBLIC AFFAIRS**

**Embargoed until 10:00 am EDT
October 14, 2003**

Contact: Randy Clerihue 202-326-4040

**TESTIMONY OF STEVEN A. KANDARIAN
Executive Director
PENSION BENEFIT GUARANTY CORPORATION
Before the
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE**

Mr. Chairman, Ranking Member Breaux, and Members of the Committee, Good morning. I am Steven A. Kandarian, Executive Director of the Pension Benefit Guaranty Corporation (PBGC). I want to thank you for holding this hearing on the financial health of PBGC and the future of defined benefit pension plans, and for your continuing interest in the retirement security of America's workers.

PBGC was created as a federal corporation by the Employee Retirement Income Security Act of 1974 (ERISA). PBGC protects the pensions of nearly 44 million workers and retirees in more than 32,000 private defined benefit pension plans. PBGC's Board of Directors consists of Secretary of Labor, who is the chair, and the Secretaries of the Treasury and Commerce.

PBGC insures pension benefits worth \$1.5 trillion and is responsible for paying current and future benefits to nearly 1 million people in over 3,200 terminated defined benefit plans. Benefit payments totaled \$2.5 billion dollars in FY 2003. We expect benefit payments to grow to nearly \$3 billion in FY 2004.

Defined benefit pension plans continue to be an important source of retirement security for 44 million American workers. But there has been a sharp deterioration in the funded status of pension plans, and the PBGC now has a record deficit as the result of the recent terminations of large underfunded plans.

When underfunded pension plans terminate, three groups can lose: participants can see their benefits reduced, other businesses can see their PBGC premiums go up, and ultimately Congress could call on taxpayers to support the PBGC.

Recently, the Administration issued its initial set of proposals to deal with the problem of pension underfunding. It has four parts:

- First, as the necessary initial step toward comprehensive reform of the funding rules, it improves the accuracy of pension liability measurement to reflect the time structure of each pension plan's benefit payments. This would be accomplished by measuring a plan's liabilities using a yield curve of highly-rated corporate bonds to calculate the present value of those future payments.
- Second, it requires better disclosure to workers, retirees, investors and creditors about the funded status of pension plans, which will improve incentives for adequate funding.
- Third, it provides new safeguards against underfunding by requiring financially troubled companies with highly underfunded plans to immediately fund or secure additional benefits and lump sum payments. Similarly, it prohibits unfunded benefit increases by those severely underfunded plans sponsored by corporations with below investment-grade debt ratings.
- And fourth, it calls for additional reforms to protect workers' retirement security by improving the funded status of defined benefit plans.

Labor Assistant Secretary Ann Combs and then Treasury Under Secretary Peter Fisher testified on July 15 before a joint hearing of subcommittees of the House Committee on Education and the Workforce and the House Committee on Ways and Means about these proposals. In my testimony today I would like to focus on plan underfunding, PBGC's financial condition, and the structural challenges facing the defined benefit system that need to be addressed with additional reforms.

As of December 31, 2000, total underfunding in the single-employer defined benefit system was less than \$50 billion. Because of declining interest rates and equity values, as of December 31, 2002 – two years later – the total underfunding in single-employer plans exceeded \$400 billion, the largest number ever recorded. Even with recent rises in the stock market and interest rates, PBGC projects that underfunding still exceeds \$350 billion today. (See Chart 1.)

When the PBGC is forced to take over underfunded pension plans, the burden often falls heavily on workers and retirees. In some cases, participants lose benefits that were earned but not guaranteed by the pension insurance system. In all cases, workers lose the opportunity to earn additional benefits under the terminated pension plan.

PBGC's premium payers – employers that sponsor defined benefit plans – also pay a price when an underfunded plan terminates. Although PBGC is a government corporation, it is not backed by the full faith and credit of the U.S. government and receives no federal tax dollars. When PBGC takes over underfunded pension plans, financially healthy companies with better-funded pension plans end up making transfers to financially weak companies with chronically underfunded pension plans. If these transfers from strong to weak plans become too large, then over time strong companies with well-funded plans may elect to leave the system.

In the worst case, PBGC's deficit could grow so large that the size of the premium increase necessary to close the gap would be unacceptable to responsible premium payers. If this were to occur, Congress could call upon U.S. taxpayers to pick up the cost of underfunded pension plans through a Federal bailout of PBGC. In essence, all taxpayers would shoulder the burden of paying benefits to the 20 percent of private-sector workers who currently enjoy the security of a defined benefit plan.

PBGC's Deteriorating Financial Condition

As a result of record pension underfunding and the failure of a number of plan sponsors in mature industries, PBGC's financial position has deteriorated sharply in the last two years. During FY 2002, PBGC's single-employer insurance program went from a surplus of \$7.7 billion to a deficit of \$3.6 billion – a loss of \$11.3 billion in just one year. The \$11.3 billion loss is more than five times larger than any previous one-year loss in the agency's 29-year history. Moreover, based on our latest unaudited financial report, the deficit had grown to \$8.8 billion as of August 31, 2003. (See Chart 2.) Changes in PBGC's deficit result from a number of factors including changes in interest rates, asset values, and probable terminations, as well as new claims.

The title of this hearing asks whether America's pensions will be the next savings and loan crisis. PBGC has sufficient assets on hand to pay benefits for a number of years in the future. But, there are serious structural issues that require fundamental reform to the defined benefit system now. In addition, PBGC's deficit is the largest in its history and is still growing. Some have suggested that these issues should be addressed "at some point." It is our view, however, that the best time to address these matters is before a crisis point. Current pension funding rules have acted to delay needed pension funding. Employers find that they are hit with substantial funding requirements when they can least afford them. Deferring action until a crisis point would risk subjecting the entire pension system to similar but much more serious strains in the future.

The General Accounting Office (GAO) has found that the health of PBGC's single-employer insurance program requires the attention of policy makers. Because of PBGC's extraordinary one-year loss, the dramatic increase in pension underfunding, and the risk of additional large claims on the insurance program, GAO recently placed the single-employer insurance program on its "high risk" list. GAO points to systemic problems in the private-sector defined benefit system that pose serious risks to PBGC. For example, the insured participant base continues to shift away from active workers, falling from 78% of all insured participants in 1980 to only 53% in 2000. In addition, GAO notes that the insurance risk pool "has become concentrated in industries affected by global competition and the movement from an industrial to a knowledge based economy." My hope is that GAO's "high risk" designation will spur reforms to better protect the primary stakeholders in the pension insurance system – participants and premium payers.

Reasons for PBGC's Current Financial Condition

PBGC's record deficit has been caused by the failure of a significant number of highly underfunded plans of financially troubled and bankrupt companies. (See Chart 3.) These include the plans of retailers Bradlees, Caldor, Grand Union, and Payless Cashways; steel makers including Bethlehem, LTV, National, Acme, Empire, Geneva, and RTI; other manufacturers such as Singer, Polaroid, Harvard Industries, and Durango; and airlines such as TWA. In addition, PBGC has taken over the failed US Airways pilots' plan. Pension claims against PBGC for 2002 alone were greater than the total claims for all previous years combined. At current premium levels, it would take about 12 years of premiums to cover just the claims from 2002.

During the last economic downturn in the early 1990s, the pension insurance program absorbed what were then the largest claims in its history -- \$600 million for the Eastern Airlines plans and \$800 million for the Pan American Airlines plans. Those claims seem modest in comparison to the steel plans we have taken in lately: \$1.3 billion for National Steel, \$1.9 billion for LTV Steel, and \$3.9 billion for Bethlehem Steel. Underfunding in the financially troubled airline sector is larger still, totaling \$26 billion as of December 31, 2002.

PBGC premiums have not kept pace with the growth in pension claims or in pension underfunding. (See Chart 4.) Premium income has fallen since 1996 to about \$800 million per year, even though Congress lifted the cap on variable-rate premiums that year. The premium has two parts: a flat-rate charge of \$19 per participant, and a variable-rate premium of 0.9 percent of the dollar amount of a plan's underfunding, measured on a "current liability" basis. As long as plans are at the "full funding limit," which generally means 90 percent of current liability, they do not have to pay the variable-rate premium. That is why Bethlehem Steel, the largest claim in the history of the PBGC, paid no variable-rate premium for five years prior to termination, despite being drastically underfunded on a termination basis.

Some have argued that PBGC overstates its deficit because it values its liabilities based on private annuity purchase rates compiled from information provided by insurance companies, even though PBGC does not buy annuities in the private market. We disagree. For an explanation of how PBGC measures its liabilities, see Appendix A.

Disclosure of Termination Liability

Some have also argued that it makes no sense to disclose the funded status of an ongoing plan in terms of its termination liability, as has been proposed by the Administration. They believe that publishing termination liability will lead workers to believe that their plans will terminate.

Since ERISA's beginning in 1974, more than 160,000 defined benefit plans insured by PBGC have voluntarily terminated in standard terminations. The number of plans peaked in 1985 at about 112,000. Since then, there has been a sharp decline, primarily among small plans, to about 32,000 plans in 2002. In the last seventeen years alone, employers have voluntarily terminated more than 95,000 plans covering about 6.5 million participants. In contrast, during the same period, only 1,800 plans were trustees by PBGC.

Some also argue that disclosing termination liability will force companies to make contributions beyond what is necessary to meet future liabilities. The Administration strongly disagrees with any suggestion that pensions will only be funded at appropriate levels if information about the cost of paying off a plan's benefit obligations is withheld from workers. Workers have a right to know whether their benefits will be funded if there is a change in the status of the firm they work for.

This is not a hypothetical concern. It is clear that the current liability disclosure methods are inadequate to inform workers about the funded status of their benefits. For example, in its last filing prior to termination, the US Airways pilots' plan reported that it was 94 percent funded on a current liability basis. At termination, however, it was only 35 percent funded on a termination basis -- with total underfunding of \$2.2 billion. As a result, the US Airways pilots were shocked to learn just how much of their promised benefits would be lost.

For these reasons, the Administration has proposed increasing the transparency of information about pension plan funding. Under current law, most workers and investors are not provided with timely information about the funding of corporate pension plans, and this uncertainty can have a negative impact on the stock prices of plan sponsors. The Administration proposes to increase the timeliness and accuracy of this disclosure by requiring that all plan sponsors disclose each year the value of their plan's assets and liabilities measured on both an ongoing and a termination basis.

PBGC's Reasonably Possible and Probable Terminations

In addition to actual claims from terminated underfunded plans, PBGC reports two other kinds of claims in its financial statements -- "reasonably possible" claims from underfunded plans that might terminate over the next several years, and "probable" claims from plans that are likely to terminate. Some have questioned whether it is appropriate for PBGC to report claims for plans that have not yet terminated, and argue that the criteria for classifying underfunded plans as "probable" or "reasonably possible" claims are not transparent. As detailed in Appendix C, the criteria for classifying plans as "probable" or "reasonably possible" are described in the notes to PBGC's financial statements. Furthermore, PBGC follows generally accepted accounting principles (GAAP) in reporting "probable" and "reasonably possible" claims in the financial statements. PricewaterhouseCoopers LLP, through PBGC's Inspector General, performed an independent audit of the financial statements and issued an unqualified opinion.

There is a degree of management judgement required when classifying claims as "probable" or "reasonably possible." However, from 1987 through 2002, 87 percent of the dollar amount of cumulative "probable" claims subsequently became actual claims; 6 percent continue to be considered "probable;" and only 7 percent of claims accrued during those 16 years are no longer considered "probable" and have been removed from claims for probable terminations.

CHALLENGES FACING THE DEFINED BENEFIT PENSION SYSTEM

The funding of America's private pension plans has become a serious public policy issue. Recent financial market trends – falling interest rates and equity returns – have exposed underlying weaknesses in the pension system, weaknesses that must be corrected if that system is to remain viable in the long run. In addition to falling interest rates and equity returns, there are serious challenges facing the defined benefit system: substantial underfunding, adverse demographic trends, and weaknesses in the pension funding rules.

While my testimony today focuses on single-employer defined benefit plans and PBGC's single-employer insurance program, I want to note that multiemployer plans and PBGC's multiemployer insurance program are subject to many of the same economic pressures and challenges. As a result, the Administration is concerned about proposals that would weaken multiemployer plan funding. It is likely that PBGC's multiemployer insurance program will show a deficit for the first time as of September 30, 2003.

Concurrent Falling Interest Rates and Stock Market Returns

The unprecedented, concurrent drops in both equity values and interest rates have caused the unfunded liabilities of most defined benefit pension plans to increase dramatically over the last three years. (See Chart 5.) Some argue that the current problems are cyclical and that they will disappear as the stock market recovers, but it is not reasonable to base pension funding on the expectation that the unprecedented stock market gains of the 1990s will repeat themselves.

In order to understand how pension plans got so underfunded, it is important to consider how mismatching assets and liabilities affects pension plan funding levels. Pension plan liabilities tend to be bond-like in nature. For example, both the value of bonds and the value of pension liabilities have risen in recent years as interest rates fell. Were interest rates to rise, both the value of bonds and the value of pension liabilities would fall. The value of equity investments is more volatile than the value of bonds and less correlated with interest rates that impact pension liabilities. Most companies prefer equity investments because they have historically produced a higher rate of return than bonds. These companies are willing to accept the increased risk of equities and interest rate changes in exchange for expected lower pension costs over the long term. Similarly, labor unions support investing in equities because they believe it results in larger pensions for workers. Investing in equities rather than bonds shifts some of the risks of this approach to PBGC.

Pension Underfunding

Any pension underfunding is a matter of concern and may pose risks to plan participants and the PBGC. In ongoing, healthy companies, an increase in the amount of underfunding can affect how secure workers feel about their pension benefits, even though the actual risk of loss may be low, at least in the near-term. Of immediate concern is chronic underfunding in companies with debt below investment-grade or otherwise financially troubled, where the risk of loss is much greater. Some of these financially troubled companies have pension underfunding significantly greater than their market capitalization.

As detailed in our most recent annual report, plans that are sponsored by financially weak companies had \$35 billion in unfunded vested benefits. Of this \$35 billion, about half represented underfunding in airline and steel plans. We expect underfunding in financially troubled companies to exceed \$80 billion at the end of FY 2003. As I previously noted, the Administration has already made specific legislative recommendations to require financially troubled companies with highly underfunded plans to immediately fund or secure additional benefits and lump sum payments. The Administration believes that this measure will prevent companies that cannot afford to fund additional pension benefits from making new pension promises they cannot keep.

Demographic Trends

Demographic trends are another structural factor adversely affecting defined benefit plans. Many defined benefit plans are in our oldest and most capital intensive industries. These industries face growing pension and health care costs due to an increasing number of older and retired workers.

Retirees already outnumber active workers in some industries. (See Chart 6.) In some of the plans we have trusteeed in the steel industry, only one out of every eight pension participants was an active worker. The *Detroit Free Press* recently reported that pension, retiree health and other retiree benefits account for \$631 of every Chrysler vehicle's cost, \$734 per Ford vehicle, and \$1,360 for every GM car or truck. In contrast, pension and retiree benefit costs per vehicle for the U.S. plants of Honda and Toyota are estimated to be \$107 and \$180 respectively. In a low-margin business, retiree costs can have a serious impact on a company's competitiveness.

Demographic trends have also made defined benefit plans more expensive. Americans are living longer in retirement as a result of earlier retirement and longer life spans. Today, an average male worker spends 18.1 years in retirement compared to 11.5 in 1950, an additional seven years of retirement that must be funded. (See Chart 7.) Medical advances are expected to increase life spans even further in the coming years.

WEAKNESSES IN THE FUNDING RULES

When PBGC trustees underfunded plans, participants often complain that companies should be legally required to fully fund their pension plans. The fact is, current law is simply inadequate to fully protect the pensions of America's workers when their plans terminate. There are many weaknesses with the current funding rules. I would like to focus on six:

Funding Targets

First, the funding targets are set too low. Employers can stop making contributions when the plan is funded at 90 percent of "current liability." The definition of current liability is a result of past legislative compromises, and has no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants, premium payers and taxpayers.

Current liability assumes the employer will continue in business. As a result, it doesn't recognize the early retirements – often with subsidized benefits – that take place when an employer goes out of business and terminates the pension plan. Current liability also doesn't recognize the full cost of providing annuities as measured by group annuity prices in the private market. If the employer fails and the plan terminates, pension benefits are measured against termination liability, which reflects an employer's cost to settle pension obligations in the private market.

For example, in its last filing prior to termination, Bethlehem Steel reported that it was 84 percent funded on a current liability basis. At termination, however, the plan was only 45 percent funded on a termination basis – with total underfunding of \$4.3 billion. (See Chart 8.) Similarly, in its last filing prior to termination, the US Airways pilots' plan reported that it was 94 percent funded on a current liability basis. At termination, however, it was only 35 percent funded on a termination basis – with total underfunding of \$2.2 billion. (See Chart 9.) It is no wonder that the US Airways pilots were shocked to learn just how much of their promised benefits would be lost. In practice, a terminated plan's underfunded status can influence the actual benefit levels. Under the Administration's already-announced transparency proposal, participants would have been aware of the lower funding level on a termination basis.

Contribution Holidays

Second, the funding rules often allow “contribution holidays” even for seriously underfunded plans. Bethlehem Steel, for example, made no cash contributions to its plan for three years prior to plan termination, and US Airways made no cash contributions to its pilots' plan for four years before the plan was terminated. When a company contributes more than the minimum required contribution, it builds up a “credit balance” for minimum funding. It can then treat the credit balance as a payment of future required contributions, even if the assets in which the extra contributions were invested have lost some or all of their value.

Risk of Loss

Third, the funding rules do not reflect the risk of loss to participants and premium payers. The same funding rules apply regardless of a company's financial health, but a PBGC analysis found that nearly 90 percent of the companies representing large claims against the insurance system had junk-bond credit ratings for 10 years prior to termination. (See Chart 10.)

Minimum/Maximum Funding Range

Fourth, the minimum funding rules and the limits on maximum deductible contributions require companies to make pension contributions within a narrow range. Under these minimum and maximum limits, it is difficult for companies to build up an adequate surplus in good economic times to provide a cushion for bad times.

Lump Sum Payments

Fifth, current liability does not include reasonable estimates of expected future lump sum payments. Liabilities must be calculated as if a plan will pay benefits only as annuities. Even if it is clear that most participants will choose lump sums, and that these lump sums may be more expensive for the plan than the comparable annuity, the minimum funding rules do not account for lump sums because they are not part of how current liability is calculated.

Contribution Volatility

Sixth, because of the structure of the funding rules under ERISA and the Internal Revenue Code, defined benefit plan contributions can be extremely volatile. After years of the funding rules allowing companies to make little or no contributions, many companies are suddenly required to make contributions of hundreds of millions of dollars to their plans at a time when they are facing other economic pressures. Although the law's complicated funding rules were designed, in part, to minimize the volatility of funding contributions, the current rules clearly have failed to achieve this goal. Masking current market conditions is neither a good nor a necessary way to avoid volatility in funding contributions.

PBGC PREMIUMS

As I noted earlier, because PBGC is not backed by the full faith and credit of the federal government and receives no federal tax dollars, it is the premium payers – employers that sponsor defined benefit plans – who bear the cost when underfunded plans terminate. Well-funded plans represent the best solution for participants and premium payers. However, PBGC's premiums should be re-examined to see whether they can better reflect the risk posed by various plans to the pension system as a whole.

PENSION CONTRIBUTION RELIEF

Congress has been asked to enact legislation that replaces interest rates for the no longer issued 30-year Treasury bond to discount pension liabilities. The Administration agrees that the 30-year Treasury bond rate should be replaced.

Corporate Bond Rates

Earlier this year, the Administration proposed that pension liabilities be discounted for two years using a blend of corporate bond rates before phasing in to a methodology utilizing a corporate bond yield curve that would more accurately match pension plans' discounting methods to the duration of their liabilities. On October 8, 2003, the House passed the "Pension Funding Equity Act of 2003" (H.R. 3108), a bill that would provide a two-year replacement rate for the historic 30-year Treasury rate. This bill is consistent with the transitional portion of the Administration's proposal over the same time frame. The Administration looks forward to working further with Congress to enact a permanent method of discounting pension liabilities.

In 2002, Congress passed legislation that temporarily changed the pension discount rate from 105 percent to 120 percent of 30-year Treasury bonds to provide funding relief to plan sponsors. Replacing the 120 percent of 30-year Treasuries with a corporate rate will provide additional short-term funding relief of \$26 billion over the next two years – about a 10 percent reduction in corporation pension contributions.

The Senate Finance Committee recently reported out a pension bill – the National Employee Savings and Trust Equity Guarantee Act (NESTEG). NESTEG includes a yield curve that is consistent with the position favored by the Administration. While the Administration supports using a yield curve to more accurately discount pension liabilities, it strongly opposes the provision that would eliminate, suspend, or weaken the Deficit Reduction Contribution (DRC) that was enacted in 1987 to protect workers.

The Administration understands the pressures placed on employers by funding rules that do not operate as well as they should. The DRC is a part of a system of flawed funding rules, which should be reviewed and reformed. The current funding rules often act to disguise market conditions and to permit funding holidays even as plans are in reality becoming more underfunded. When the DRC kicks in, it often hits employers with huge contribution increases when they can least afford them. The Administration is deeply concerned about volatility in funding requirements, and believes that reforms should dampen out contribution volatility. A well-structured system of funding rules would limit sudden increases in employer contribution requirements, while producing stronger pension funding over time.

The appropriate place to consider any further funding relief, however, is in the context of comprehensive reform to strengthen long-term funding. To grant funding relief with no offsetting action to address systemic underfunding would, in our view, be ill advised. Earlier this year, the Administration testified that action to reform pension discounting was needed to increase liability measurement accuracy, and thereby better inform our discussion of comprehensive funding reform. The Administration continues to believe that our proposal for accuracy and transparency is an important first step before undertaking measures that would change the funding rules.

If we eliminate the DRC without providing an effective replacement for it, workers can suffer large losses when sponsors of substantially underfunded plans promise benefits that they cannot afford to pay. The DRC requires those plan sponsors to fund the cost of new benefits over 3 to 7 years – a faster schedule designed to get plans funded before companies fail and transfer their liabilities to PBGC. If the DRC were eliminated, plan sponsors could fund new benefits over 30 years as they did before the 1987 reforms.

PBGC analyzed the effects of granting a three-year waiver from the DRC. We estimate that suspending the DRC for the next three years would increase underfunding by \$40 billion. As noted earlier, PBGC estimates that overall pension underfunding in plans sponsored by financially weak companies exceeded \$80 billion as of December 31, 2002. A DRC waiver would allow companies representing nearly \$60 billion of this "at risk" liability to stop making accelerated pension contributions. Yet the average funded ratio of these plans, if they were to terminate, is less than 60 percent.

PBGC also examined the underfunded plans that have terminated since 2000 to see how many would have been exempt from the DRC. These were the riskiest plans of all – so risky that they terminated. Yet nearly 90 percent of them would have been off the hook under the Finance Committee's DRC provision, including Bethlehem Steel, whose plan had \$4.3 billion in unfunded benefits at termination, the largest in PBGC's history.

The Administration's goals are to put plans on a path toward better funding. Eliminating the DRC without an effective substitute would undercut workers' retirement security. The appropriate timing of employer pension contributions should be considered only as part of broader comprehensive reforms that strengthen pension funding over the long term.

Required Pension Contributions

Defined benefit pension plans have always required substantial contributions by the companies sponsoring the plans. These contributions can be funded either with cash contributions or with investment returns.

For example, because of unprecedented investment returns during the late 1990s, defined benefit plan sponsors made little or no pension contributions for many years. From 1995 to 1999, total pension contributions averaged only \$26 billion per year in 2002 dollars. (See Chart 11.) To put that into perspective, total contributions during the early 1980s averaged \$63 billion per year in 2002 dollars. Over this period, the amount of benefits insured by PBGC has more than doubled, adjusted for inflation. As a result, current pension contributions are not inconsistent with the levels of contributions in periods with more normal equity returns.

Some have suggested that 2002 was an artificially low point in the market and that it is inappropriate to base funding decisions on PBGC's deficit and total pension underfunding during that time. It is worth noting that, even including the market declines in 2001 and 2002, real rates of return on equity investments for the 20 years ending in 2002 are significantly above the long-term historical average (1926 through 2002). (See Chart 12.) It is not reasonable for plan sponsors to base pension funding on the expectation that the stock market gains of the last decade will continue indefinitely.

Some have alleged that there would be adverse macroeconomic consequences of these increased required contributions. They contend that the economy would suffer because funds that could have been used for capital improvements and jobs growth would be used for pension funding. The Administration believes that this argument is incorrect. Pension contributions go back into the economy as savings and provide a source of capital investment in our economy – investment that creates jobs and growth. The Council of Economic Advisers recently estimated the economic impact if plan sponsors fully met their pension obligations, and found that the effects on the macroeconomy would not be substantial.

REFORMS NEEDED TO PROTECT THE DEFINED BENEFIT SYSTEM

Mr. Chairman, we must make fundamental changes in the funding rules that will put underfunded plans on a predictable, steady path to better funding. Improvements in the funding rules should set stronger funding targets, foster more consistent contributions, mitigate volatility, and increase flexibility for companies to fund up their plans in good economic times.

At the same time, we must not create any new disincentives for companies to maintain their pension plans. Pension insurance creates moral hazard, tempting management and labor at financially troubled companies to make promises that they cannot or will not fund. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years and shutdown benefits, which are essentially severance benefits, may never be pre-funded. In exchange for smaller wage increases today, companies often offer more generous pension benefits tomorrow, knowing that if the company fails the plan will be handed over to PBGC. These companies are using their pension plans to unfairly shift their labor costs to responsible companies and their workers. At some point, these financially strong companies may exit the defined benefit system, leaving only those companies that pose the greatest risk of claims.

The Administration has already introduced proposals to more accurately measure pension liabilities, improve pension disclosure, and protect against underfunding. In addition, the Departments of Labor, Commerce, and the Treasury and PBGC are actively working on comprehensive reform, including reform of the funding rules, to improve the retirement security of American workers and retirees. We are examining how to eliminate some of the risk shifting and moral hazard in the current system. We are crafting proposals to get pension plans better funded, especially those at risk of becoming unable to meet their benefit promises. And we are re-evaluating statutory amortization periods and actuarial assumptions regarding mortality, retirement, and the frequency and value of lump sum payments to ensure they are consistent with the goal of improved funding.

CONCLUSION

Mr. Chairman, we should not pass off the cost of today's pension problems to future generations. If companies do not fund the pension promises they make, someone else will have to pay -- either workers in the form of reduced benefits, other companies in the form of higher PBGC premiums, or taxpayers in the form of a PBGC bailout.

Thank you for inviting me to testify. I will be happy to answer any questions.

APPENDIX A**MEASURING PBGC's LIABILITIES****Matching the Private Annuity Market**

Annuity prices are what insurance companies charge to assume responsibility for a company's pension plan and make a series of future payments to its workers. When a company voluntarily terminates its pension plan, it must defease the plan liabilities by providing an annuity or a lump sum payment to its workers. Group annuity prices are the most objective measure of the cost of defeasing a plan's liabilities in the marketplace.

GAO, in its February 2003 report on interest rates for pension calculations, noted that "Congress intended that the interest rates used in current liability and lump-sum calculations should reflect the interest rate underlying group annuity prices." PBGC's interest factors were specifically developed to approximate group annuity purchase prices, as required by regulation for more than 25 years. An October 2000 study by the American Academy of Actuaries and the Conference of Consulting Actuaries compared the actual cost to terminate a plan with the cost that would have resulted if PBGC's assumptions had been used. Their results showed that PBGC's assumptions yielded a measure of termination liability within 3 to 4 percent of the actual cost.

Since ERISA was enacted in 1974, more than 160,000 defined benefit plans insured by PBGC have voluntarily terminated in standard terminations. Today, PBGC insures about 32,000 plans, down from an all-time high of 112,000 plans in 1985. The companies sponsoring each of these terminating plans were required to defease their plans' liabilities either by purchasing annuities in the private annuity market or by making lump sum distributions to their workers.

If PBGC's "price" to close out a plan in a distress or involuntary termination were lower than the market price to close out a plan in a standard termination, there would be an uneven playing field for plan sponsors. This could create an incentive for sponsors of poorly funded plans to file for distress terminations with PBGC because it would be cheaper than a standard termination.

For a discussion of PBGC's calculation of interest factors, please see Appendix B – "PBGC Procedure for Setting Interest Factors Used to Value Liabilities for PBGC Financial Statements."

APPENDIX B**PBGC Procedure for Setting Interest Factors Used
to Value Liabilities for PBGC Financial Statements**

PBGC has historically derived its valuation assumptions by surveying private sector annuity prices and selecting a valuation interest factor that, when combined with PBGC's mortality assumption, will match the market price of single-premium, nonparticipating group annuity contracts for terminating plans. To determine these interest factors, PBGC gathers pricing data from insurance companies that are providing annuity contracts to terminating pension plans through a quarterly "Survey of Nonparticipating Single Premium Group Annuity Rates." The survey is distributed by the American Council of Life Insurers (ACLI) and provides PBGC with "blind" data; that is, the survey is conducted in such a way that PBGC is unable to match responses with the companies that submitted them. The survey is sent to approximately 17 insurance companies.

The survey asks insurers to provide the net annuity price for annuity contracts for plan terminations. PBGC uses the information from the survey to develop interest factors, which are adjusted to the end of the year using an average of the Moody's Corporate Bond Indices for Aa and A-rated corporate bonds for the last five trading days of the month. The adjusted interest factors are published in mid-December for use in January. The interest factors are then further adjusted each month on the basis of the average of the Moody's bond indices.

The interest factors, when used along with the mortality table specified in PBGC regulations, reflect the rate at which pension sponsors could have settled their liabilities, not including administrative expenses, in the market place for single-premium nonparticipating group annuities issued by private insurers.

GAO's February 2003 report noted that, "of all the alternative rates, PBGC's interest rate factors have the most direct connection to group annuity purchase rates." However, GAO also noted that the calculation of PBGC's interest factors is not transparent and the identity of the insurance companies surveyed is not known, raising ambiguity about the extent to which PBGC's interest factors reflect the current broad market for group annuities. PBGC would not object to an independent review of the methodology for developing these interest factors that lead to the calculation of a market price. While we believe that our survey methodology replicates the market price of private group annuity contracts, PBGC is certainly open to considering alternative methods of calculating annuity purchase factors.

APPENDIX C**PBGC's Probable and Reasonably Possible Claims**

"Probable" claims are included in accrued liabilities in the financial statements. When an economic event that is likely to lead to plan termination has occurred on or before the date of the financial statements, GAAP requires that the estimated amount of the "probable" claim (net of estimated recoveries and plan assets) be accrued. This is consistent with the Financial Accounting Standards Board Statement No. 5 – *Accounting for Contingencies*, which requires that a loss contingency must be recorded if (1) it is likely (probable) that one or more future events will confirm the loss and (2) the amount can be measured (reasonably estimated).

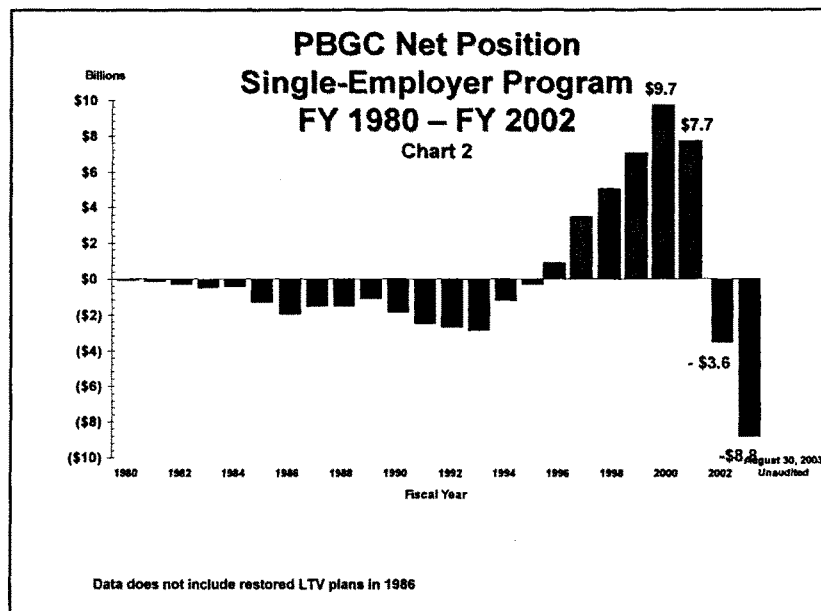
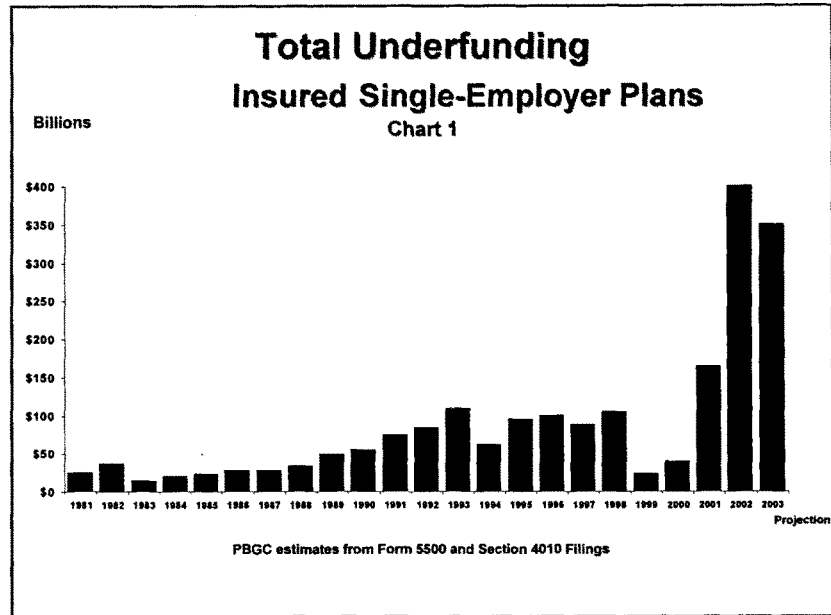
Criteria used for classifying a claim as "probable" are listed in the footnotes to the financial statements and include:

- (1) the plan sponsor is in chapter 11 liquidation or comparable insolvency proceeding with no known solvent controlled group member;
- (2) the plan sponsor files for a distress plan termination; or
- (3) PBGC seeks involuntary plan termination.

In addition to "probable" claims, PBGC also reports "reasonably possible" contingent claims generally represent underfunding in plans sponsored by companies with below-investment-grade bond ratings. While losses from "reasonably possible" plans are not yet "probable terminations" and are not accrued for financial statement purposes, GAAP requires this financial exposure to be disclosed in the footnotes to PBGC's financial statements.

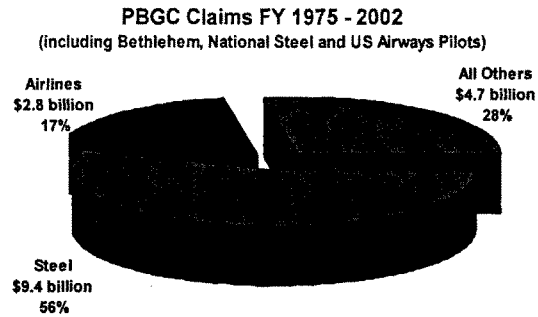
Other criteria used for classifying a company as "reasonably possible" are listed in the footnotes to the financial statements and include:

- (1) the plan sponsor is in Chapter 11 reorganization;
- (2) the plan has a funding waiver pending or outstanding with the IRS;
- (3) the plan has missed minimum funding contributions; or
- (4) the plan sponsor has no bond rating but the ratio of long-term debt plus unfunded benefit liability to market value of shares is 1.5 or greater.



Historic PBGC Claims

Chart 3

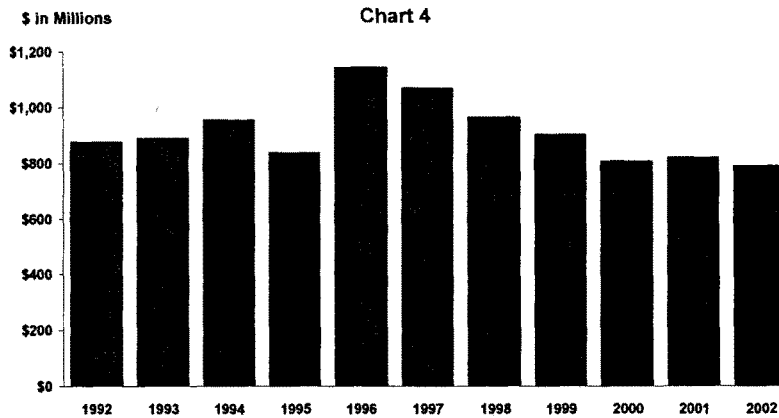


Note: Historically, Steel has represented less than 3% of participants covered by PBGC and Airlines less than 2%.

Single-Employer Premium Income

FY 1992 – FY 2002

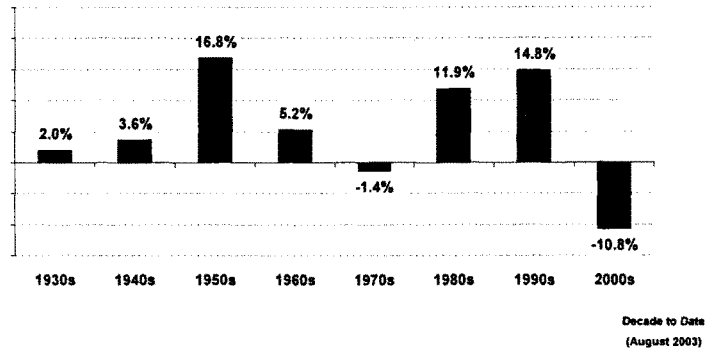
Chart 4



NOTE: The variable rate premium was capped until 1996

Real Equity Returns

Chart 5

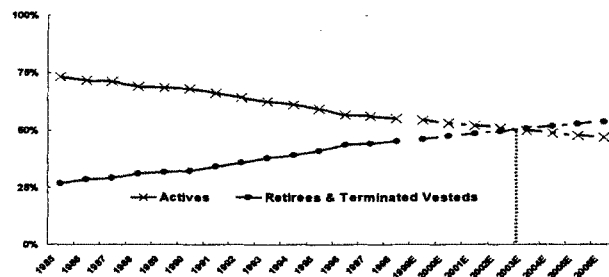


Source: Ibbotson Associates

Participants in Defined Benefit Pension Plans

[1985 - 2006^{est}]

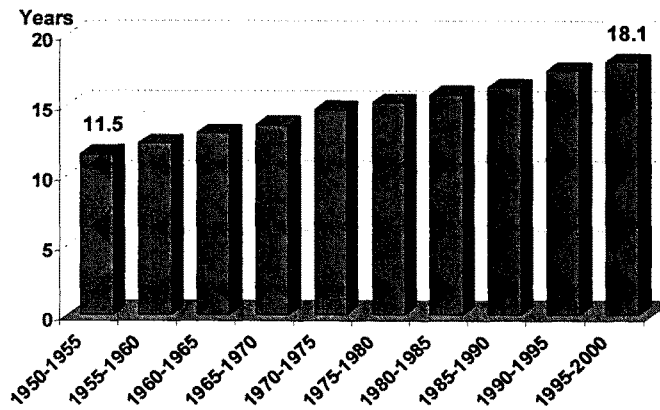
Chart 6



Source: U.S. Department of Labor
 Pension and Welfare Benefits Administration
 Abstract of 1998 Form 5500 Annual Reports Winter 2001 - 2002

Average Number of Years Spent in Retirement (Males)

Chart 7



Bethlehem Steel

Chart 8

	1996	1997	1998	1999	2000	2001	2002
Current Liability	78%	91%	99%	96%	86%	84%	NR
DRC?	Y	N	N	N	N	NR	NR
Participant Notice?	Y	Y	N	N	N	N	N
VRP?	\$15 million	\$17 million	N	N	N	N	N
Actual Contributions	\$354 million	\$32.3 million	\$30.9 million	\$ 8.1 million	\$0	\$0	\$0

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities \$4.3 billion

US Airways Pilots

Chart 9

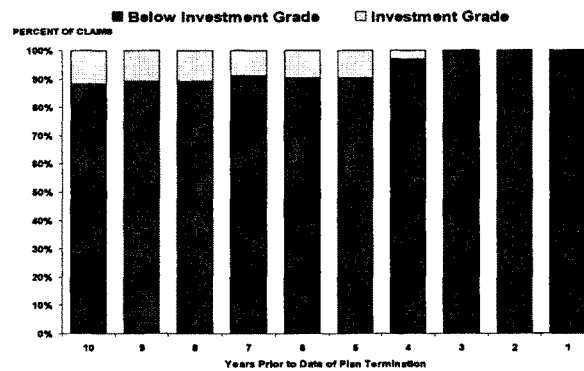
	1996	1997	1998	1999	2000	2001	2002
Current Liability	97%	100%	91%	85%	104%	94%	NR
DRC?	N	N	N	N	N	N	NR
Participant Notice?	N	N	N	N	N	N	N
VRP?	\$4 million	N	N	N	\$2 million	N	N
Actual Contributions	\$112.3 million	\$0	\$45 million	\$0	\$0	\$0	\$0

Termination Benefit Liability Funded Ratio 35%

Unfunded Benefit Liabilities \$2.2 billion

Debt Ratings for Large Claims

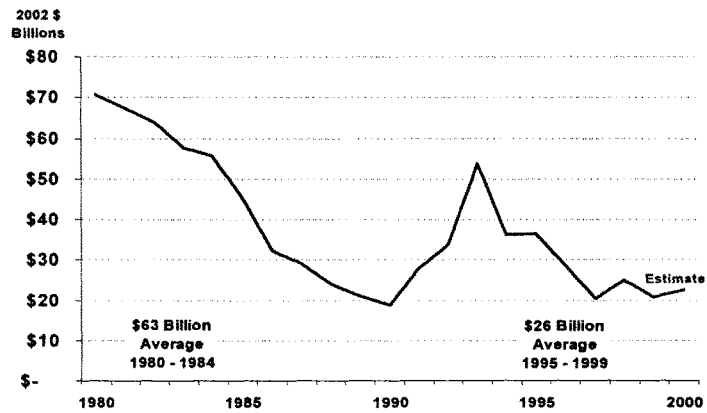
Chart 10



NOTE: Based on 27 of PBGC's largest claims representing over 50% of all claims.

Historic Single-Employer Contributions

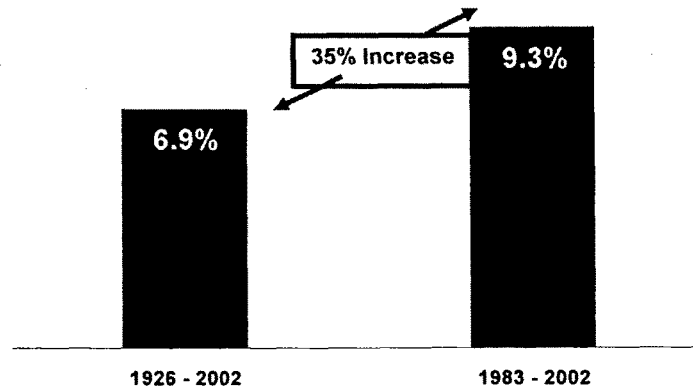
Chart 11



Equity Performance

Real Rates of Return

Chart 12



Source: Ibbotson's Large Stock Returns

The CHAIRMAN. Steve, thank you very much.

Now let me turn to—my script says Peter. It is Mark.

Mr. WARSHAWSKY. It is Mark.

The CHAIRMAN. Thank you, Mark. We have made that correction for the record. Mark Warshawsky, Assistant Secretary of Economics, at the Department of Treasury is also with us. We thank you. From you, Mark, we will turn to William Sweetnam. So please proceed.

STATEMENT OF MARK WARSHAWSKY, ACTING ASSISTANT SECRETARY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.; ACCOMPANIED BY WILLIAM SWEETNAM, BENEFITS TAX COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. WARSHAWSKY. Thank you, Mr. Chairman.

I am pleased to appear before you with PBGC Executive Director Steve Kandarian and William Sweetnam, Benefits Tax Counsel of the U.S. Treasury, to discuss defined benefit pension plans. I will discuss the Administration's current proposal and ongoing activities aimed at strengthening the long-term health of the defined benefit pension system and improving the retirement security of pension participants. Bill and I will be happy to answer any questions you may have.

Despite repeated attempts to enhance the funding rules of defined benefit pensions, it seems that, even excluding the impact of recent market downturns, conditions have not improved. But we believe that, with improvements, the defined benefit system will continue to be a viable and important part of the American retirement system.

As you are aware, in July the Administration released its proposal to improve the accuracy and transparency of pension information. This proposal is designed to secure and strengthen Americans' pensions by improving the accuracy of the pension liability discount rate, increasing the transparency of pension plan information, and strengthening safeguards against pension underfunding.

A predicate step to fixing the pension funding rules is to ensure that we accurately measure the pension liabilities on which those rules rely. Our most immediate task is to replace the 30-year treasury rate used in measuring pension liabilities for minimum funding purposes. We propose that the discount rates be drawn from a corporate bond yield curve. Use of a yield curve helps insure that measured liabilities reflect accurately the timing of future expected benefit payments.

We appreciate that there is important activity in both houses of Congress on this issue. In the Senate Finance Committee, the Chairman's modification to the Nest Egg Act of 2003 includes a discounting provision that is quite similar to the Administration's proposal. We were happy to see that provision included in the bill.

On the House side, the Administration believes that H.R. 3108, the Pension Funding Equity Act, is an important first step toward providing a permanent replacement of the interest rate now used to determine pension liabilities. H.R. 3108's proposed discounting method for the next 2 years is broadly consistent with the Adminis-

tration's proposal over the same timeframe. We are encouraged by the passage of this bill.

My written testimony provides a detailed overview of the Administration's proposal. One new point I would like to stress today is that the Treasury Department has begun active development of our own yield curve based on interest rates for high-quality zero coupon, call-adjusted corporate bonds of varying maturities using a widely accepted methodology. We are very pleased with our progress in this regard and do not foresee any difficulty in generating the yield curves for use in discounting pension plans if the Administration's proposal becomes law.

Currently, both the Senate and the House bills also contain calls for comprehensive pension reform. The Administration supports and appreciates these provisions and looks forward to working with Congress on these important issues. Americans have a broadly shared interest in adequate funding of employer-provided defined benefit plans. At the same time we must be sure that our pension rules encourage rather than discourage employer participation. We have begun the hard work needed to develop pension funding rules that will be less complex, more flexible, logically consistent, and will achieve the goal of improving the security of defined benefit plans.

Major areas that require our attention include funding targets, the funding path, and the PBGC guarantee and premium structure. We will seek to develop better, more meaningful, funding targets. This includes current and accurate asset measurement and enhanced liability measurement. We will examine in particular retirement, lump sum, and mortality assumptions.

Improvements to funding rules should mitigate volatility by providing firms with more consistent contribution requirements and increasing flexibility for firms to fund up their plans in good times. Specific issues that need to be examined here include maximum contribution deductibility, credit balances, the volatility caused by the minimum funding back stop or the deficit reduction contribution requirement, new benefit restrictions for certain underfunded plans whose sponsors are financially troubled, and shortening the length of new benefit amortization. Other issues include the extent of benefit guarantee coverage and the structure of the PBGC premiums.

As I stated at the outset, the Administration's permanent discount rate replacement proposal is designed to strengthen Americans' retirement security by producing accurate measure of pension liabilities. Accurate measurement is the essential first step in ensuring that pension promises made are pension promises kept. We believe that the discount rate proposal, combined with the other administration proposals, represents a strong start toward improving and strengthening defined benefits pension system.

We have committed to developing a further proposal for fundamental reform and are working diligently to fulfill that commitment. We look forward to sharing the proposal with Congress in the near future and to continue to work together toward a more secure system.

Thank you.

[The prepared statement of Mr. Warshawsky follows:]

Testimony of Mark J. Warshawsky
Acting Assistant Secretary for Economic Policy
U.S. Department of the Treasury
Before the Special Committee on Aging
United States Senate

**THE ADMINISTRATION'S ACTIVITIES TO IMPROVE THE RETIREMENT
SECURITY OF DEFINED BENEFIT PENSION PARTICIPANTS**

Chairman Craig, Ranking Member Breaux, and distinguished members of the Committee. I am pleased to appear before you with Pension Benefit Guaranty Corporation (PBGC) Executive Director Steven Kandarian and William Sweetnam, Benefits Tax Counsel of the U.S. Treasury, to discuss defined benefit pension plans. I will discuss the Administration's proposals and ongoing activities aimed at strengthening the long-term health of the defined benefit pension system and thereby improving the retirement security of defined benefit pension participants. Bill and I will be happy to answer any questions you may have.

We all want to improve the retirement security for the nation's workers and retirees by strengthening the financial health of the voluntary defined benefit system they rely upon. We believe that with improvements, the defined benefit system will continue to be a viable and important part of the American retirement system. Despite repeated attempts to improve the current defined benefit pension funding system, it is that, even without the impact of market downturns over the past few years, conditions have worsened over time. PBGC's current estimate suggests that pension plans in aggregate are underfunded by more than \$350 billion. PBGC's most recent unaudited figures show liabilities outstripping assets by \$8.8 billion.

Before discussing comprehensive reform, I would like to discuss the proposal that the Administration has already put forward in this area. In July, we released the Administration's Proposal to Improve the Accuracy and Transparency of Pension Information. This proposal is designed to strengthen and secure Americans' pension security by:

- Improving the accuracy of the pension liability discount rate;
- Increasing the transparency of pension plan information; and
- Strengthening safeguards against pension underfunding.

THE ADMINISTRATION'S PROPOSAL FOR ACCURATELY MEASURING PENSION LIABILITIES

Fixing the pension funding rules won't help unless we give our immediate attention to ensure that we accurately measure the pension liabilities on which those rules rely. Our most immediate task is replacing the 30-year Treasury rate used in measuring pension liabilities for minimum funding purposes. The Administration's proposal is the necessary first step in the reform process. The Administration believes that any permanent change in pension discounting rules should not contribute to future pension plan underfunding. The Administration seeks to have pension liabilities accurately measured, in order to provide the necessary foundation for reform of the funding rules. Once we know the extent of these pension liabilities, we can ensure that pension promises made are pension promises kept.

We appreciate that there is important activity in both Houses of Congress on the issue. In the Senate, the Finance Committee Chairman's Modification to the "National Employee Savings and Trust Equity Guarantee Act of 2003" includes a discounting provision that is quite similar to the Administration's proposal. We were happy to see that provision included in the bill.

On the House side, the Administration believes that H.R. 3108, the Pension Funding Equity Act of 2003, is an important first step toward providing a permanent replacement for the interest rate now used to determine pension liabilities. H.R. 3108's proposed discounting method for the next two years is broadly consistent with the Administration's proposal over the same time frame. We are encouraged by the passage of this bill.

We face two near-term concerns that must be addressed in getting to a permanent replacement of the current discount rate.

First, firms that sponsor defined benefit plans already are budgeting their pension contributions for the next several years. Near-term changes to the current rules that would increase pension contributions above current expectations could disrupt these firms' existing short-term plans.

Second, many underfunded plans are already facing sharp increases in their required pension funding contributions. Thus, while we must ultimately ensure that liabilities are measured accurately and that firms appropriately fund the pension promises they have made, an abrupt change from the current system could do more short-term harm than good by triggering plan freezes or terminations.

The Importance of the Discount Rate in Pension Funding

To determine minimum required funding contributions, a plan sponsor must compute the present value of the plan participants' accrued future benefit payments, which is known as the plan's current liability. The present value of a benefit payment due during a particular future year is calculated by applying a discount factor to the dollar

amount of that payment. This discount factor converts the dollar value of the future payment to today's dollars. Current liability is simply the sum of all these discounted future payments.

Pension liabilities must be accurately measured to ensure that pension plans are adequately funded to protect workers' and retirees' benefits and to ensure that minimum funding rules do not impose unnecessary financial burdens on plan sponsors. Liability estimates that are too low will lead to plan underfunding, potentially undermining benefit security. Pension plan liability estimates that are too high lead to higher than necessary minimum contributions, reducing the likelihood that sponsors will continue to operate defined benefit plans.

Computing pension liabilities is basically a two-step process. In the first step, the plan actuary estimates the payments that will be made to retirees each year in the future. The pension plan's actuary makes these estimates based on the plan's terms, and estimates of how long current employees will work before retirement and receive benefits in retirement. Estimating the future stream of payments involves considerable judgment on the part of the actuary.

Step two, converting the value of future payments to today's dollars, is, by comparison, simple and rather mechanical. To convert payments in a future year to present dollars, the estimated payments are simply adjusted by the appropriate discount rate. Although some discounting schemes use the same discount rate to compute the present value of payments for all future years, it is no more difficult to compute the present value using different discount rates for each future year.

Choosing the right rate is the key to accurate pension discounting. The wrong rate leads to inaccurate estimates of liabilities that can be either too high or too low.

Therefore, the primary goal of the Administration's proposal to replace the 30-year Treasury rate can be summed up in one word: accuracy. Without first accurately measuring a plan's pension liabilities, the minimum funding rules cannot ensure that the firm is setting aside sufficient funds to make good on its pension promises to its workers. Accurate liability measures also provide a firm's investors with valuable information about the pension contributions that will be made from the firm's earnings. Accurate liability measures allow workers and retirees to monitor the health of their pension plans. Finally, accurate liability measures allow the PBGC to better monitor the health of the overall pension system.

Pension Discounting under Current Law

Since 1987, federal law has required that pension liabilities that determine minimum pension contributions be computed using the interest rate on the 30-year Treasury bond. In 2002, Congress passed legislation that temporarily changed the discount rate to provide funding relief to plan sponsors. This temporary fix expires at the end of this year.

Dissatisfaction with the continued use of the 30-year rate, even on an interim basis, has been expressed by many Members of Congress and pension sponsors. This dissatisfaction and the recognition that the 30-year rate is no longer an accurate discount rate make it imperative that a replacement be promptly enacted. This is why the Administration applauds the passage of the House Bill.

The Administration's Proposal for Accurately Measuring Pension Liabilities

The Administration believes that corporate bond rates, not Treasury rates, should be the basis for the pension discount methodology. Three key issues need to be addressed in selecting a permanent replacement for the 30-year Treasury rate: the time structure of a pension plan's future benefit payments; the appropriateness of smoothing the discount rate; and the appropriate relationship between the discount rate and the computation of lump sum payments.

The proposal I will now set forth deals with each of these issues.

1. *Pension discount rates should be based on market determined interest rates for similar obligations.*

The terms of pension contracts are not market determined because pensions are not bought and sold in an open market and pension sponsors do not compete with one another for participants. However, group annuity contracts, which are very similar to employer sponsored pensions, *are* sold in a competitive market by insurance companies. Group annuity contracts obligate the seller to provide a stream of annual cash payments, in exchange for a competitively priced premium, to individuals covered by the policy. We take the view, as Congress has in the past, that pension discount rates should reflect the interest rate underlying group annuity prices. These assets held by annuity providers consist largely of bonds issued by firms with high credit ratings. Furthermore, the insurance companies issuing the group annuity contracts also have high credit ratings.

Therefore, the Administration proposes that the new pension discount rate be based upon an index of interest rates on high-grade corporate bonds.

2. *Pension discount rates should be designed to ensure that liabilities reflect the timing of future benefit payments.*

Each pension plan has a unique schedule of future benefit payments - or cash flow profile - that depends on the characteristics of the work force covered by the plan. These characteristics include the percent of participants that are retired, the age of current workers covered by the plan, the percent receiving lump sums and whether the covered work force has been growing or shrinking over time. Plans with more retirees and older workers, more lump sum payments, and shrinking workforces will make a higher percentage of their pension payments in the near future, while plans with younger

workers, fewer retirees, fewer lump sums, and growing workforces will make a higher percentage of payments in later years.

One approach to liability computation applies the same discount rate to all future payments regardless of when they occur. This approach produces inaccurate liability estimates because it ignores a basic reality of financial markets: that the rate of interest earned on an investment or paid on a loan varies with the length of time of the investment on the loan. If a consumer goes to a bank to buy a Certificate of Deposit, he will expect to receive a higher rate on a five-year CD than on a one-year CD. Likewise, that same consumer who borrows money to buy a house expects to pay a higher interest rate for a 30-year than a 15-year mortgage.

Pension discount rates must recognize this simple financial reality. Pension payments due next year should be discounted at a different, and typically lower, rate than payments due 20 years from now. Why is this important? Pension plans covering mostly retired workers that use a 20-year interest rate to discount all their benefit payments will understate their true liabilities. This will lead to plan underfunding that could undermine retiree pension security, especially for workers who are nearing retirement age. Proper matching of interest rates to payment schedules cannot be accomplished using any single discount rate.

Computing liabilities by matching interest rates on zero-coupon bonds that mature on the same date that benefit payments are due is not complicated. Once expected pension cash flows are calculated by the actuary it is no more difficult to discount benefit payments on a spreadsheet with an array of different interest rates than it is if only one discount rate is used.

It is also important to understand that the discount rate used does not change the actual obligation -- the liability is what it is. Choosing the proper discount rate gives us an accurate measure in today's dollars of future benefit payments; it does not change those payments. But if we don't measure that value properly today, plans may not have sufficient funds set aside in the future to make good on those pension promises.

The Administration proposes that benefit payments made in future years be discounted to today's dollars using discount rates taken from a corporate bond yield curve (a table or graph that illustrates the interest rates on bonds that mature at different dates in the future). Liabilities would be computed by using interest rates on zero-coupon bonds that mature on a specific date in the future to discount benefit payments due to be made that same year.

Furthermore, implementation of the yield curve would be phased in over five years. The phase-in would start with the use of a single long-term corporate bond rate for the first two years. In the third year a phase-in to the appropriate yield curve discount rate would begin. The yield curve would be fully applicable by the fifth year.¹

This phase-in period would provide some short term funding relief for sponsors, and achieve the desired level of accuracy at the end of five years.

3. *Pension discount rates should be based on current financial conditions.*

Pension liability computations should reflect the current market value of future benefit payments -- this is a key component of accuracy. Plan sponsors and investors are interested in the current value of liabilities in order to determine the demands pension liabilities will place on the company's future earnings. Workers and retirees are interested in the current value of liabilities so that they can determine whether their plans are adequately funded.

Some argue that discount rates should be averaged (smoothed) over long periods of time. Under current law they are smoothed over four years. Such smoothing is intended to reduce the volatility of liability measures and helps make contribution requirements more predictable. Unfortunately, current smoothing rules reduce the accuracy of liability measures while failing to achieve stability in annual contributions. Smoothing can mask changes in pension plan solvency of which workers and retirees should be aware. As I mentioned earlier, we would like to work with Congress to identify permanent reforms of the funding rules that would reduce volatility in annual contributions, without the corollary effect of reducing measurement accuracy.

The Administration proposes to decrease smoothing gradually during the five-year phase-in. In years one and two, four year smoothing is maintained. Smoothing is reduced in years three and four and finally, in year five, set at a 90-day moving average to eliminate the impact of day-to-day market volatility. This will provide an appropriately current measure of interest rates.

4. *Pension discount rates should apply to annuities and lump sum payments in a consistent and neutral manner.*

Retirees and departing workers in some plans can opt to receive a single payment for their pension benefits rather than regular payments over their lifetimes. The value of these so-called lump sum payments is the present value of the worker's expected retirement annuity. Using an artificially low discount rate for lump sums creates an incentive for participants to choose lump sums rather than the annuity.

The Administration proposes that the yield curve used to measure pension liabilities also be used to compute lump sum payments so as to reflect accurately the life expectancy of retirees in the amounts that they will receive. In order to minimize the disruption of plans of workers who will receive benefits in the immediate future, lump sums would be computed using the 30-year Treasury rate as under current law in years one and two. In the third year a phase-in to the appropriate yield curve discount rate

would begin. By the fifth year lump sums will be computed using the yield curve.

Workers receiving lump sums, especially those in their 50's, 60's and older, would be better off under the Administration's proposal than under an alternative that would compute lump sums using a single long term corporate interest rate. Workers electing lump sums at relatively younger ages would have a higher proportion of their future payments discounted at long-term interest rates than workers retiring at relatively older ages. This is appropriate given the different time frames over which they had been expecting to receive their benefits. While moving from the 30-year Treasury rate to any corporate bond based rate will result in lower lump sum payments for younger workers who leave their jobs, under the yield curve approach older workers closer to retirement age will be little affected by the change.

However, some workers who will soon be leaving their jobs have been anticipating taking their pension benefits in the form of a lump sum with the expectation that those benefits would be computed using the 30-year Treasury rate. Computing lump sums using the yield curve rather than the 30-year Treasury rate may result in lower lump sum payments for those who leave at a young age. The Administration's proposal is for the benefits of younger and older workers alike to be consistently and accurately valued, whether a lump sum or a traditional annuity benefit.

Development and Use of the Yield Curve

Yield curves used to discount pension benefit payments have been available for a number of years. One example of such a pension yield curve is the one developed by Salomon Brothers (now Citibank) in 1994 for the Securities and Exchange Commission. Monthly Citibank yield curves can be found on the Society of Actuaries web site at <http://www.soa.org/sections/pendis.html>. In the past months, the Treasury Department has begun active development of our own yield curve based on interest rates for high-quality, zero-coupon, call adjusted corporate bonds of varying maturities using an alternative widely accepted methodology. We are very pleased with our progress in this regard and do not foresee any difficulty in generating yield curves for use in discounting pension plan payments if the Administration's proposal becomes law.

Treasury would use a formal notice and comment rulemaking process to ensure transparency and to incorporate input from all interested parties in final development of the yield curve. Although the groundwork is well established, we certainly plan to work with all stakeholders to finalize the methodological details of the ultimate yield curve.

Because discounting pension payments using a yield curve is already considered a best practice in financial accounting, large sponsors are almost certainly making these computations now or know how to make them.² Sponsors certainly know what their expected future pension cash flows are.

The mechanics of discounting future pension cash flows are in fact quite simple. This is true whether one uses a single rate to discount all payments or uses different rates

to discount payments made in each year. Such calculations, which can be done with a simple spreadsheet, should not pose serious problems even for small plans let alone plans sponsored by large, financially sophisticated firms.

As I stated at the outset, the Administration's permanent discount rate replacement proposal is designed to strengthen American's retirement security by producing accurate measures of pension liabilities. And accurate measurement is the essential first step in ensuring that pension promises made are pension promises kept.

ADMINISTRATION PROPOSALS TO INCREASE TRANSPARENCY AND STRENGTHEN PENSION FUNDING

There are two other reform tasks that the Administration recommends for immediate attention. First, the transparency of information pertaining to pension plan funding needs to be increased. Under current law most workers and retirees are not provided with timely information about the funding of their pension plans. We propose to remedy this by requiring that each year sponsors disclose to participants the value of their defined benefit pension plan assets and liabilities measured on both a current liability and a termination liability basis.

The Administration also proposes that certain financial data already collected by the PBGC from companies sponsoring pension plans with more than \$50 million of underfunding should be made public. We propose that the available information be limited to the underfunded plan's market value of assets, termination liability and termination funding ratios. This data is more timely and accurate than what is publicly available under current law.

Second, the Administration proposes to restrict benefit increases for certain underfunded plans whose sponsors are financially troubled. When firms with below investment grade credit ratings increase pension benefit promises, the costs of these added benefits stand a good chance of being passed on to the pension insurance system, frustrating the benefit expectations of workers and retirees and penalizing employers who have adequately funded their plans. Under the Administration's proposal, if a plan sponsored by a firm with a below investment grade credit rating has a funding ratio below 50 percent of termination liability, benefit improvements would be prohibited, the plan would be frozen (no accruals resulting from additional service, age or salary growth), and lump sum payments would be prohibited unless the employer contributes cash or provides security to fully fund these added benefits. When a plan sponsor files for bankruptcy the PBGC's guarantee limits would also be frozen.

It should also be noted that Treasury is in the process of updating mortality assumptions. In order to ensure that liabilities are measured accurately, mortality estimates need to be made from the most up-to-date and accurate tables available. On September 22, 2003, the Treasury and the Internal Revenue Service published in the Internal Revenue Bulletin, a request for comments on the mortality tables used in determining current liabilities. The notice invites comments on methods of projecting

mortality and on factors, in addition to age and year of birth, that might be appropriately reflected in any new tables that may be adopted.

FUNDAMENTAL REFORM

Currently both the Senate and House bills contain calls for comprehensive reform. The Administration supports and appreciates these provisions and looks forward to working with Congress on this important issue. The Administration commends those in Congress who have recognized that there is a need for reform and we look forward to your continued leadership on these issues. Americans have a broadly shared interest in adequate funding of employer-provided defined benefit pensions. Without adequate funding, the retirement income of America's workers will be insecure. This by itself is a powerful reason to pursue improvements in our pension system. At the same time, we must always be mindful that the defined benefit pension system is voluntary. Firms offer defined benefit pensions to their workers as an employee benefit, as a form of compensation. Our pension rules should thus be structured in ways that encourage, rather than discourage, employer participation.

Key aspects of the current system frustrate participating employers while also failing to produce adequate funding. We thus have multiple incentives to improve our pension system, and to thus better ensure both the availability and the viability of worker pensions. We have rolled up our sleeves and begun the hard work needed to create a system that more clearly and effectively funds pension benefits. We will develop a pension system that will be less complex, more flexible, logically consistent, and will achieve the goal of improving the security of defined benefit plans. Major areas that require our prompt attention include:

1. Funding Targets

We will seek to develop better, more meaningful, funding targets.

Asset Measurement. Under existing rules, assets can be measured as multi-year averages rather than current values. Pension funding levels can only be set appropriately if both asset and liability measures are current and accurate. Failure to accurately measure assets and liabilities contributes to funding volatility.

Liability Measurement

We also intend to examine how the application of actuarial assumptions in the current rules may contribute to funding volatility and to inaccurate measurement of pension liabilities. For example, companies do not want to be surprised to find they have inadequately funded their plans because the mortality tables used in the funding rules are outdated or because those rules fail to account for lump sum payments. We will examine:

- a. *Retirement Assumptions.* Retirement assumptions made by plan actuaries need to reflect the actual retirement behavior of those covered by the plan.
- b. *Lump Sums.* Liability computations for minimum funding purposes need to include reasonable estimates of expected future lump sum withdrawals that are determined by methodologies that are broadly consistent with other estimates of plan obligations.
- c. *Mortality.* As noted above, Treasury is in the process of updating mortality assumptions.

2. Funding Path

The current system of funding rules and asset and liability measurement has been constructed, in part, to dampen the volatility of firms' funding contributions. Yet current rules fail to do so. After years of making few or no contributions at all, many firms are facing precipitous increases in their annual funding requirements. This outcome is frustrating to business and it has failed to provide adequate funding for workers and retirees. Improvements to funding rules should mitigate volatility, provide firms with the ability to make more consistent contributions, and increase flexibility for firms to fund up their plans in good times. Specific issues in the funding rules that need to be examined include:

- a. *Contribution Deductibility.* Together, minimum funding rules and limits on maximum deductible contributions require sponsors to manage their funds within a narrow range. Raising the limits on deductible contributions would allow sponsors to build larger surpluses to provide a better cushion for bad times.
- b. *Credit Balances.* If a sponsor makes a contribution in any given year that exceeds the minimum required contribution, the excess plus interest can be credited against future required contributions. These credit balances - mere accounting entries - do not fall in value even if the assets that back them lose value. Credit balances allow seriously underfunded plans to avoid making contributions, often for years, and contribute to funding volatility.
- c. *Volatility Caused by the Minimum Funding Backstop.* The current minimum funding backstop, known as the deficit reduction contribution, causes minimum contributions of underfunded plans to be excessively volatile from year to year.
- d. *New Benefit Restrictions.* The current Administration proposal is to restrict benefit increases for certain underfunded plans whose sponsors are financially troubled. We are looking at areas where it may be appropriate to expand this proposal.
- e. *Benefit Amortization.* The amortization period for new benefits can be up to 30 years long. This may be excessive. We will also look at other statutorily defined amortization periods.

3. Other Issues

- a. *Extent of Benefit Coverage.* It may be advisable to limit or eliminate guarantees of certain benefits that typically are not funded, such as shutdown benefits.
- b. *Multi-employer Plan Problems.* Multi-employer plans operate under a different set of rules than single-employer plans. Despite these regulatory differences, the same principles of accuracy and transparency should apply to multi-employer plans, and we will be reviewing the best ways to accomplish this.
- c. *PBGC Premiums.* PBGC's premium structure should be re-examined to see whether it can better reflect the risk posed by various plans to the pension system as a whole.

CONCLUSION

As I stated at the outset, the Administration's permanent discount rate replacement proposal is designed to strengthen American's retirement security by producing accurate measures of pension liabilities. And accurate measurement is the essential first step in ensuring that pension promises made are pension promises kept. The discount rate replacement proposal, combined with the other Administration proposals, represent a strong start towards improving and strengthening the defined benefit pension system. We have committed to developing a proposal for fundamental reform and we are working diligently to fulfill that commitment. We look forward to sharing a proposal with Congress in the near future and continuing to work together towards a more secure defined pension system.

¹ In years 1 and 2 pension liabilities for minimum funding purposes would be computed using a discount rate that falls within a corridor of between 90 and 105 percent of a 4 year weighted average of the interest rate on a long-term highly-rated corporate bond. In years 3 and 4, pension liabilities would be an average of that calculated using a long-term corporate rate and that using a yield curve. In year 3, the corporate rate would receive a 2/3 weight and the yield curve a 1/3 weight. In year 4 the weights would be switched and in year 5 liabilities would be computed using the yield curve.

²- See Financial Accounting Standard 87.

The CHAIRMAN. Mark, thank you very much. Bill?

Mr. SWEETNAM. They just brought me along to answer questions.

The CHAIRMAN. You are the heavy. All right.

Thank you all very much. Let me ask a couple of questions first, before I go to you individually, that you may all wish to respond to, and we can just start with you, Barbara, and ask you to react to these two broader questions.

Today's testimony shows that using a higher interest rate to value pension funds show improvement in the book value without changing their fundamental values. What should the Congress consider when determining the most appropriate interest rate formula?

Ms. BOVBJERG. I would be pleased to respond first on that. GAO has, in fact, done a report on this. I would like to say if there were a perfect solution, we would have recommended it. We did not recommend a specific interest rate to use, but we looked at a variety of alternatives. We were looking to determine how well whether they matched group annuity prices, which is really what the rates should do, and how transparent these measures were, how subject to manipulation they might be.

In looking at them, we found that every measure we examined had some aspect that was positive, some aspect that was negative. What we did also discover is that they are all higher than the 30-year treasury rate.

Pretty clearly, Congress has to do something. The rate probably needs to go up. But I think it is important to realize, as you say, that raising the rate creates an appearance of improving funding in the plans without actually doing so, that it will reduce premium revenue to PBGC. It will increase risk for PBGC and for the workers and participants in these plans.

Because such a change is not really funding reform, it does indeed seem prudent to look at this as a relatively short-term action and then taking more time to look at a more comprehensive solution to the overall problem.

The CHAIRMAN. Thank you. Steve? Do you wish to comment on that?

Mr. KANDARIAN. Actually, Treasury is probably more——

Mr. WARSHAWSKY. I will take that in our question.

In our considerations, and in review of this issue, we looked at many different proposals and many different ideas. In fact, I think we pretty much came across all of the things that were included in the GAO report back in February.

What we came up with and proposed is the use of a corporate bond yield curve. The motivations we had for that were several. We felt that corporate bonds were the appropriate risk because a pension after all, is a corporate obligation and therefore corporate bonds represent the right risk strata.

At the same time, we felt it was very important that the yield curve be included in that discount rate as an accurate representation, best practice of valuing liabilities. In any prudent measurement of liabilities by any financial institution whether it is a bank or other financial institution, there is a reflection of the different interest rates on the different maturities of a liability. We felt that was appropriate to be included here, as well.

There certainly are pluses and minuses to any proposal but we felt on balance this was the best proposal. Obviously there is an immediate need for enactment.

We also recognize that transition is appropriate and therefore we proposed a 2-year transition period to a corporate yield curve.

The CHAIRMAN. A comment, Bill?

Mr. SWEETNAM. We had heard a lot about people being concerned about manipulation of an interest rate, which I think was one of the reasons why 30-year treasury rate was used a number of years ago. But this is not the case when we look at an overall bond index, and some people have been promoting a bond index. The Administration is looking at a yield curve, we think that the breadth of the data that is coming in, in order to provide that yield curve, really lends itself away from any sort of manipulation by people in trying to change the interest rate in order to play with funding.

I think the other thing is that the Administration will be putting out, if we go forward with a yield curve proposal, what we would do would be we would propose a request for comments on how we would develop this yield curve. Now, we have some ideas at Treasury on how you would develop a yield curve. But we would really want to make that yield curve as transparent as possible, so that plan sponsors could understand how the Treasury Department was establishing that yield curve.

So I think that does get at people's concerns with manipulation, it really handles those concerns.

The CHAIRMAN. Would you agree with Barbara, that this alone should be used only as a short-term measure? That there are other—and we will ask questions of those—fundamental reforms necessary?

Mr. SWEETNAM. The Administration is currently taking a complete review of the funding rules, as Mark had talked about. So yes, I think that this is just really one piece in the overall strategy of how do you deal with the financial health of defined benefit plans.

The CHAIRMAN. Let me go then, I think the second question begins to touch on that funding issue. Barbara, you mentioned it, that the plans recently taken over by PBGC went from fully funded to seriously underfunded in a very short period of time. At the same time, the companies sponsoring the plans were going bankrupt and likely had little cash to contribute to their plans. As a practical matter, to what extent could strengthened minimum funding rules have reduced losses to the single employer benefit program? Do you wish to respond to that, and again, to all of the panelists?

Ms. BOVBJERG. One thing I would like to start off with is the balance between employers who are having difficulties, and protecting PBGC. Such employees are having difficulties even before they have to put in increased contributions to their pension plans. It is easy to sympathize with that concern.

At the same time, PBGC and the workers and the retirees need to be assured that there will be something left from them in their pension plan, and need to feel that even companies that are having difficulties have made, contributions to their pension plan a priority.

In thinking about this, and Dave Walker wanted to make sure that I talked about this a little bit today, we have some concern about doing something broadly that would make funding appear better or would reduce contributions for most sponsors when, in fact, you might consider a more targeted approach, or perhaps something that is quite temporary that would involve the concept of loan instead of grant, something of that nature. I think that the concern about PBGC is not just getting through this tough period, but is looking at the long run and how PBGC will be ensuring a shrinking group of defined benefit plans.

The CHAIRMAN. That question, Steve?

Mr. KANDARIAN. Sure. Mr. Chairman I think that one of the big problems in the system is that the funding rules were built in and designed in a way to try to get relatively consistent or nonvolatile contributions. Essentially companies with these kinds of plans were worried that if they were forced to use spot values for assets, spot values for their liability measurement interest rates, they would have very volatile contributions. They wanted to avoid that.

While we support that goal, the actual mechanisms that were put in place did not work. You still have these long funding holidays. You still have these very large spikes later on when things go against these plans in terms of liability measures and asset values.

So as Barbara mentioned before, Bethlehem Steel's plan suggested that on a current liability basis, this measure that was put into law in 1987, it was 84 percent funded. Yet when it came into the agency it really was only 45 percent funding on a termination basis. That results in large losses not only to this agency, but also to the workers who were promised those benefits.

USAirways' pilots plan was even worse. It was 94 percent funded on a current liability basis. Yet it was only 35 percent funded on a termination basis. It was especially impactful in that case because the pilots had very large pensions. Our guarantee limits set by Congress cover the vast majority of the people at 100 percent of all benefits, all accrued vested benefits but not the pilots because their benefits are above that maximum guarantee. So you saw a great deal of consternation on the part of these pilots understandably.

So the intent was to smooth out this whole system in terms of contributions. Those measures really have not worked and those are things we are looking at very closely within the administration, in terms of our funding reform proposal.

Mr. WARSHAWSKY. I would add two other items to answer that question. First of all, we feel that one way of smoothing the volatility of contributions is that corporations should have the ability to fund in good times when the contributions are easier to be made. That way that provides a cushion for riding out more difficult times. That might have helped in some of these plan terminations.

Another consideration to make is that many of these plans have had plan sponsors who have had difficulties over a period of time, many, many years before they entered bankruptcy. We believe that prudent funding is appropriate even in those circumstances and benefits promises made should be kept.

Mr. SWEETNAM. I would just want to echo what Mark was saying. The important thing to realize is that we have built these funding rules over time with a lot of the changes being made with regard to let us raise revenues. So if we raise revenue in the tax code, we can cut back on some of the funding requirements. It has always been sort of this hodgepodge of rules. It is really, I think, important for us to step back and say where do we really want our funding rules to be going, especially in this context of whether we want to continue the viability of defined benefit plans. That is something that we are working on very hard in the Administration.

The CHAIRMAN. Thank you. I have other questions of you individually, but before I get to those, let me turn to one of the committee members, my colleague who has just joined us, Senator Carper. Would you wish to make any opening comments or start a questioning line?

Senator CARPER. Yes, if I could just ask a couple of questions that would be great, Mr. Chairman. How are you?

The CHAIRMAN. I am fine.

Senator CARPER. Nice to see you.

The CHAIRMAN. Welcome back.

Senator CARPER. To our witnesses, thanks for joining us today.

I apologize for missing your statements. We have got, as you know, a bunch of other hearings going on and we are trying to cover all of those bases. So I missed what you had to say. If I ask you a couple of questions on things you have already addressed, please bear with me.

The title for today's hearing, as I recall, was something to the effect of is this the next savings and loan crisis. Let me just ask each of you, is it?

Mr. WARSHAWSKY. We do not believe that there is an immediate crisis. Unlike the savings and loans or financial institutions, which have to have basically demand deposits or deposits which have to be answered in a very short period of time, defined benefit pensions are very long-term promises and they are tied in with the employment of workers. So therefore there is an attachment to the firm. So this is sort of a long-term liability.

At the same time, I think trends in this area have not been positive despite all of the attempts of addressing the issue with various funding rule changes. We believe that we can right the system and provide a more stable and permanent basis for defined benefit plans by improving the funding rules going forward. So it is certainly a problem right now, and we believe that enhancements are required.

Senator CARPER. Anybody else have a view you would like to share?

Mr. KANDARIAN. Senator, when pension promises are not fully funded, there are potentially three different groups that can be hurt. At the first level it is workers, who do not get the full amount of the pension promise that was bargained for. Their benefits, in many cases, are cut back.

At the second level, it is others in the system, other companies that have defined benefit pension plans, oftentimes well funded, who pay over time higher premiums to make up for those who did not pay for their pension promises.

At the third level, if Congress could not raise premiums high enough, if the system got too underfunded, the taxpayer could be called upon to bail out the system. I do not see the need for that in the near future, but our hope is that we can make fundamental changes to the pension system, to the funding rules in particular, to preclude the necessity for that at some point down the road.

Ms. BOVBJERG. If I could just add, Senator, I agree this is not an immediate emergency. Certainly, GAO feels that this is worthy of such high concern that we put this program on our high risk list. I would like to urge this committee, because your portfolio is aging overall, to think about this in the context of Social Security as well. We are affecting only half, unfortunately, of American workers, those who have pensions. These workers are addressing risks in their pension plans at the same time that we are discussing risks to Social Security benefits and what Social Security will look like in the future.

So with that perspective, I think it would be very important to start moving very quickly to stabilize defined benefit pensions.

Senator CARPER. Could somebody go back in time and just take us back to, I guess, the early 1970's when this legislation was originally debated and finally adopted? I want to say in 1974. Can you sort of set the table? What was the scene like then? Why was Congress and—I guess it was President—would it have been Nixon or Ford? Ford, I suppose, who felt compelled to act? Take us back in time for a moment?

Mr. SWEETNAM. ERISA, The Employee Retirement Income Security Act of 1974, which is the act that you are talking about, really stems from the bankruptcy of the Studebaker Company and the fact that the pension promises that were made to their participants were not there anymore. There were no assets to back up these promises.

I think what ERISA did, one of the things that ERISA did, was it made sure that you had a steady funding stream and required for these sorts of general tax qualified plans that companies fund the promises that they made. In fact, when I was in private practice, when I looked at a plan document for a plan prior to 1974, it was usually about maybe five pages long. Now a plan document is about 60 to 80 pages long, and what you do is you see that there is a lot of emphasis on how much is in the plan and protecting the benefits and the promises that were made to those individuals.

As time went by, what we have seen is sometimes when we are in periods when we want to raise tax revenue, we will cut back on some of the funding requirements. Sometimes when we are concerned about the PBGC, what we will do is we will put additional requirements on like this deficit reduction contribution that we are talking about now, which will sort of increase the amount of money that goes into a pension plan.

So this is what I was saying before, where it is sort of a crazy quilt of proposals on proposals that make this rather a difficult area to work through.

Now the actuaries, of course, do not think this is a difficult area, but that is what they get paid to do.

Mr. KANDARIAN. If I could just add to what Bill said.

Senator CARPER. Again, my question, I want you to take me back in time. Set the stage, 1974. What was going on?

Mr. KANDARIAN. As Bill mentioned, Studebaker went bankrupt in 1963. Back in the 1950's, actually, Packard ceased operations in 1956 and terminated its pension plan two years later in 1958.

President Kennedy set up a commission in 1962. It went dormant after a while when President Johnson came to office. In 1967, Senator Javits introduced the first iteration of ERISA. It took all the way to 1974 to get the bill passed. It was controversial at the time, especially with companies.

But essentially what Congress said in 1974 was these pension promises really are part of the wage benefit tradeoff that workers bargain for. In essence, it is not, if you will, a tip on the way out the door. These are earned benefits and they must be advance funded so the money is there for people in retirement. The money is earned now, it is given to them later.

That was the reason for the system of advanced funding. Now do you ever get truly to fully advanced funding, in terms of the requirements of the law? I would say no, we have not. At times, the system has been very well funded, primarily because the assets went up in value, or the liabilities went down based upon interest rates. But the law never really said you had to be all the time 100 percent funded.

The second thing I would say is that if you think about a spectrum of what this agency is, what PBGC is, are we really an insurance system? Where you take like risks and you assess for risk in the funding rules, you assess for risk in the premium rules? Or are you more of a transfer payment agency, if you will? Take from those who are doing better or are better off, or the rich, and give it to the less well off, the poor? Where on this spectrum do you want this system to be?

I do not think it can be at either extreme end. It is got to be someplace else. The question ends up being the policy debate is, where on that spectrum are we? Is that the right place? I think we have some concerns that the system has shifted too much toward the wealth transfer end of things and needs to be more risk-based. Those are things we are discussing within the Administration and hope to have proposals on later in the year.

Senator CARPER. Mr. Chairman, I have a couple of more questions, but let us go back to you and then maybe I can ask another one or two.

The CHAIRMAN. Let us stay with the theme, I think Senator, that you started here. Barbara, let me come back to you.

We have just seen what happened in relation to the fund and Bethlehem and the economy and certain impacts on it. Based on your analysis, which industries have companies that are most at risk of being taken over by PBGC at this time?

Ms. BOVBERG. I have to give credit where credit is due, that we get most of this information from PBGC. It is our understanding that steel, airlines, and the automobile industry are the weak points.

The CHAIRMAN. How well informed are workers about the solvency of those particular pension funds?

Ms. BOVBJERG. Workers generally are not very well-informed. These are complicated issues. They are hard to understand. Workers do not get very good information. That is why one of the elements that GAO feels should be addressed as part of a comprehensive reform is transparency.

You may have seen articles about the USAirways pilots being unable to find out what was really going on in their pension plan in its last days just before termination. That should not happen. People should know the status of their plan, what the termination liability might be, and what effect that would have on their benefits.

The CHAIRMAN. Steve, in relation to transparency, and that is almost always the better way to go, so that everyone involved is informed accurately and on a real-time basis, what can Congress do in that area to ensure transparency in these plans?

Mr. KANDARIAN. The Administration's proposal includes some improvements in transparency. We would like there to be an annual disclosure on a termination basis, as opposed to this measure called current liability, where again the pilots thought at USAirways their plan was very well funded when it was not on a termination basis, that disclosure be made on an annual basis that shows the plan's assets and liabilities. That would be fairly current data.

In addition, we have something called Section 4010 information at the PBGC. That relates to companies that are \$50 million or more underfunded on a termination basis. We collect that data. It helps us understand our risks. But by law, we cannot disclose it on a company by company basis.

We would like that information to be made public so that not only workers, and retirees would know but also shareholders of companies would have access to that information as they invest in company stock. Or creditors to companies, vendors who are shipping goods to companies would know that.

The reason we want this kind of information out there in the marketplace is because we believe while regulation has a place in the system, it is not the only thing to make the system stronger. The markets can adjust, but for markets to work, there has to be good, accurate, understandable and timely information. We think the current system does not provide that.

The CHAIRMAN. Barbara, a moment ago you brought Social Security into the discussion a bit, and certainly we are obviously very focused on that debate, and discussion are now at hand in Congress, looking at reforms of Social Security for the out-years and for the younger crowd coming I guess, probably not the baby boomers.

You also mentioned that in the context of this. Let me ask this question of you, and then I would broaden it out to the others.

There appears to be the likelihood of some short-term action being taken. Is that the approach to go? Is that the way to go to handle this problem as we look at the long-term structural change necessary in what appears to be competing goals? Those are the taxpayer and the question of, if you will, bailout, providing sufficient incentives and insuring workers.

Now putting all of that together, there is some pretty hefty competing forces there. Is there a sense of urgency to this that requires

us to act in the short-term versus short-term approaches built toward long-term solution?

Ms. BOVBJERG. I would argue that the most important thing is some sort of comprehensive approach because, as you say, there are competing interests. Certainly you do not want pension contributions to create bankruptcies. At the same time, you want employers accountable for funding the promises that they have made to workers and retirees. At the same time, PBGC is trying to ensure a really changing pool of defined benefit plans.

The number of plans has fallen dramatically in the last 20 years. The number of participants has gone up slightly. That tends to be because there are larger plans left in the system. But we have gone from being about 75 percent active workers versus 25 percent retirees to much closer to a 50–50 balance. There are clearly things that we need to think about for the long term for defined benefit pensions and how they relate to PBGC.

At the same time, I know that Congress needs to act on the interest rate. I think that is why you see a number of proposals that would just go with a new rate for a couple of years until something more comprehensive could be tried or could be considered.

I do think that it is important to look at all four of the things that we mention in our testimony, on funding rules—and I am pleased to hear that Treasury is doing work on that—on the premium structure, on the guarantees that PBGC makes, and on transparency, which of course is one of the very most important pieces.

The CHAIRMAN. Steve, the same question.

Mr. KANDARIAN. I think I would just echo Barbara's comments about the demographics especially that impact the system. In Social Security we talk about numbers of 3.4 workers for every one retiree. In this system, it is about one-to-one, one worker for one either retiree or terminated vested worker. So you have that dynamic that is in play.

In addition, the number of years spent in retirement has gone up dramatically over the last 50 years, up about 17 percent.

The CHAIRMAN. It will continue.

Mr. KANDARIAN. It will continue. As people retire younger, although that is going to level off, and live of course longer, that puts strains and stresses on the system. Company actuaries do account for that, but if a plan gets underfunded you are talking about an ever larger set of liabilities that even on the same percentage basis results in a lot more dollars of underfunding. That puts stresses on those companies and that puts stresses on the insurance system.

The CHAIRMAN. Mark, Bill?

Mr. WARSHAWSKY. Mr. Chairman, I would say that there are several considerations in terms of timing. Obviously, the need for replacement for the 30-year treasury is an immediate need, and that has to be dealt with very quickly.

At the same time, we felt it was important from the Administration's perspective to put a down payment, if you will, on some more fundamental reforms and that includes the disclosure; it includes the yield curve. At the same time we are working very diligently on a comprehensive package that would include all the consider-

ations that have been mentioned thus far. We feel as if that is something that we hope to share with you soon.

Mr. SWEETNAM. The other short-term issue that people have been talking about has been the elimination of the deficit reduction contribution for 3 years. That is a short-term solution that we do not think is a solution at all. The Administration opposes eliminating the deficit reduction contribution because as we are going forward to try to get overall funding reform, it is very difficult to start off another \$40 billion in the hole in terms of funding. So the Administration opposes elimination of the deficit reduction contribution.

The CHAIRMAN. Tom.

Senator CARPER. I want to go back in time. I am not lost in the 1970's, but I want to go back there again for just a minute.

Barbara, do you pronounce your last name—

Ms. BOVBJERG. Bovbjerg. It is much easier to say than to read.

Senator CARPER. It sure is. Why do you spell it that way?

Ms. BOVBJERG. It is those Danes.

Senator CARPER. I think you alluded to this but when this law was adopted in the early to mid-70's I do not know that we had defined contribution plans. If we did, we did not have them like we do today. At the time, a lot of people graduated. I was just getting out of the Navy then. A lot of people went to work and worked for somebody for a long time and they participated in a defined benefit plan and eventually they retired, starting about right now actually.

Today, folks just bounce all around. My wife has worked for DuPont for 27 years. I have been here with Mr. Craig for awhile, and eventually some day my wife, I expect, will have a defined contribution pension plan to draw from. Who knows, maybe we will, too.

But our children will not. In all likelihood, our children will have a far different kind of pension plan to participate in.

But what I thought I heard you say is that the number of plans is way down from where it was at its height and the number of participants in those plans is up just a little bit. When you look forward over the next several years, how do we see it trending in terms of the number of plans continue to drop, the number of participants continue to rise? What do you see?

Ms. BOVBJERG. We see that sponsors with defined benefit plans, largely small plans, are exiting the system. They are not being replaced by new sponsors. New sponsors are offering defined contribution plans as a general rule. People do like them. They allow portability, they allow choice. But they do put the risk of adequate retirement income squarely on the participant, on the worker.

Defined benefit plans reward people who stay, as you say, for most of their career in a single plan. What we have seen and we have reported on several years ago are different approaches to defined benefit plans, called hybrid plans. I know you have heard of cash balance plans that try to continue the defined benefit guarantee but have a more portable and a more accessible kind of benefit, where people can understand their benefit better or they may be able to take it with them when they leave the company.

Certainly, such innovation in defined benefit plans helps. It permits sponsors to feel that they are addressing the needs of their

workers and it does provide something for people who are leaving. But at the same time, the secular trend is clear, we are going toward defined contribution.

It is something that is worth thinking about as we think about Social Security too, about how different sources of income may complement or mirror each other. We did a report a couple of years ago on the linkage between Social Security and pensions and the relevance of that linkage to Social Security reform. So I am pleased to see that this committee is thinking about these things together. I think that is very important.

Senator CARPER. What triggers a takeover by the PBGC?

Mr. KANDARIAN. A plan terminates based upon a couple of different factors. One might be that a company is in bankruptcy and cannot get out of bankruptcy, in essence would have to liquidate unless it sheds one or more of its pension plans. An example was USAirways. It would essentially have to liquidate the company, sell off the planes, go out of business unless it shed at least one of the pension plans—in this case it was the pilots' plan—because they could not make their numbers work in their business plan to pay back the loans they needed to get out of bankruptcy with those liabilities hanging over their head.

Senator CARPER. This reminds me of the old joke about the planes about to crash, there are five people on the plane, four parachutes. Remember that story? The pilots came out without the parachute.

Mr. KANDARIAN. Right.

Other cases are when companies actually liquidate. For example, Bethlehem Steel sold off all its assets and went out of business. The acquirer of those assets did not take on the pension plan. The buyer of those assets paid roughly \$1.5 billion for all of the assets net of the assumed liabilities. The pension plan was more than \$4 billion underfunded. So the number simply would not have worked. You could not pay \$1.5 billion and take on \$4.3 billion of liabilities on top of that if you thought the economic value of those assets was only \$1.5 billion.

So the plan sits there at this company that is dissolving, and therefore comes to us. Sometimes companies do what is called a distressed termination. They put the plan to PBGC, if they meet the rules in the law. Sometimes we call the plan in from PBGC. We take the action first if we feel there is an unreasonable likelihood of increased liabilities to the corporation. That was the case in Bethlehem Steel, as more liabilities were being triggered every day, and no money was going into the plan. So it can happen either way.

But a company cannot simply say it is no longer convenient to have this plan, I will be a more competitive company if I shed these liabilities compared to my competitors. They have to show that they would not be able to stay in business essentially if they kept the plan.

Senator CARPER. Do plans that are taken over from the PBGC ever emerge from that oversight or is that it?

Mr. KANDARIAN. No, essentially, once they come to us they stay with us. There was a minor exception in terms of numbers. LTV shed its plans the first time it went bankrupt in 1986. It then be-

came more obvious that it could have afforded the plans. The agency went to court and argued the case all the way to the U.S. Supreme Court and restored those plans because we felt LTV had not really met the test of saying we could not stay in business with the plans. But other than that, the answer is no.

Senator CARPER. If you go back since 1974 to any times when our economy has trended down and we have been in recession, we had a real sharp recession in about 1982. We had a milder recession followed by jobless recovery in 1990 and 1991. Did we see the kind of takeovers by pension plans at that time that we are seeing now?

Mr. KANDARIAN. The last time the agency saw a number of large terminations was the period following the 1990 and 1991 economic slowdown. At that point in time, there were some steel plans like there were this time, but it was more the airlines. Eastern Airlines, Pan-American came in to us. Those were the two largest underfunded plans. They came in at \$600 million and \$800 million underfunded.

This time around, Bethlehem Steel's underfunding was in excess of \$4 billion. What you can see is that the size of these pension promises is growing decade to decade. The level of premiums that this agency receives has been essentially flat for a long period of time. So the funded status, the funded ratio if you will, of these plans has not changed much. They come into us typically 50 percent funded. Well, 50 percent of an ever bigger number becomes more and more exposure and you have flat premiums for this insurance system, and all of a sudden the numbers do not work.

Senator CARPER. Have we seen, either in the 1980's or the 1990's, a period of time when companies were able to—you know, the pension funds were flush, maybe the value of the assets in those funds had risen or appreciated considerably, and companies were able to take from the pension funds back to the company some of the value, some of the assets of those funds? Have we seen that occur?

Mr. SWEETNAM. During the mid-80's, there was a way that you could do a termination re-establishment of a plan. You terminate the plan, take some of the excess assets, and you re-established a new plan. Congress stopped that and put a tax on reversions.

So right now if a company terminated a plan and took the assets out, the company, would be subject to a very high tax not only income taxes on that reversion, but a very high excise tax on that conversion.

Senator CARPER. So that occurred about 15 years or so ago?

Mr. SWEETNAM. Yes.

Senator CARPER. That has not been a contributing factor?

Mr. KANDARIAN. I think it was 1986. It happened at a time when there were large leveraged buyouts and the plan excess assets were being used to finance these buyouts and Congress moved against that. As Bill mentioned, there is a 50 percent excise tax if you take it out now in most cases, other than bankruptcy. The one exception, I believe, is for health care for the same workers as have these pension promises if the plan is sufficiently well funded.

Mr. SWEETNAM. Some have stated though that by putting this excise tax, this very high excise tax on reversions, that it really says to a company you better not overfund your plan because once those

assets are in there is no way that you are going to be able to get them out.

Senator CARPER. Finally, just real succinctly if you would for me, what can be done administratively to address this crisis? I think you have already said that. I would like to hear it again, just succinctly. What can be done, should be done legislatively, to help in this cause? Somebody just tell me about the 30-year treasury bond? What would you do with respect to 30-year treasury rates?

Mr. WARSHAWSKY. As we see it, most of the solutions are legislative. With regard to your question with regard to the 30-year treasury rate, there is an immediate need for replacing that. The Administration has put forward a proposal for over a 2-year period for a transition to a corporate bond yield curve, which we feel is the most accurate and relevant measurement to be used.

Senator CARPER. What maturity?

Mr. WARSHAWSKY. A corporate bond yield curve reflects all maturities.

Senator CARPER. To how long?

Mr. WARSHAWSKY. Most yield curves are computed up to 30 years. We might be able to even go a little bit beyond that.

Senator CARPER. How quickly do we need to act on this point?

Mr. WARSHAWSKY. With regard to replacement of the discount rate, there is an immediate need because the prior stopgap expires at the end of this year. So that is an immediate need.

Senator Carper, I want to just answer one of your prior questions in terms of the choice between defined benefit and define contribution plans.

In different circumstances they are appropriate for different types of workers and they each have relative strengths and weaknesses. With regard to defined benefit plans, one strength which it does have is it offers an employee a life annuity as a payment option, and that is very advantageous to insure against the risk of outliving one's assets.

Senator CARPER. Again, just real succinctly, what can be done administratively? Two, what should we do legislatively? You have mentioned one thing that sounds like a do right now kind of deal.

Mr. SWEETNAM. One of the administrative things that is occurring now is that some plans are coming in to the IRS and asking for funding waivers. But really all that is doing is sort of postponing current funding contributions and pushing them out to the future. There really is not a lot that we can do administratively to fix this problem. I think that it really is something that is requiring legislative action.

Mr. KANDARIAN. I agree with that. Administratively, PBGC can do certain things. If we feel there was an unreasonable increase in long-run loss facing the agency, we can move first and terminate a pension plan before the liabilities grow even larger for the insurance system. We have taken steps such as that in the last few years. But most of the fix really is legislative.

Ms. BOVBJERG. I agree, it is practically all legislative. There may be some things that can be done administratively with regard to better informing participants, but those would be relatively small.

Senator CARPER. Other than the 30-year treasury fix, is there anything else we need to do this year?

Ms. BOVBJERG. No.

Senator CARPER. Mr. Chairman, the committee of jurisdiction for the kind of near-term fix that is being discussed here, who would have jurisdiction over that? Is that finance?

The CHAIRMAN. Finance.

Senator CARPER. Beyond that, some of the changes that have been suggested?

The CHAIRMAN. There are a variety of proposals out there now, and the Administration is coming up with one. The House has a version. Senator Grassley has one, Senator Gregg has another.

Mr. SWEETNAM. It is also part of the jurisdiction of the HELP Committee, too.

The CHAIRMAN. Yes, that is correct.

Senator CARPER. Mr. Chairman, thanks. You have been very generous. To our witnesses, thank you.

The CHAIRMAN. Let me ask the last question because it falls directly into what Tom was saying as to short-term, long-term.

Mark, Bill, critics of the yield curve say that it is an untested concept and that it will result in pension plans moving their investments out of the equity market. How do you respond to that?

Mr. WARSHAWSKY. It is not an untested concept. One of the corporate bond yield curves that we became aware of was developed by Salomon Brothers, now Citibank. That was in response to a request from the SEC in 1994, in terms of better implementation of the financial accounting requirements for pension plans.

The yield curve has been around since 1994 and has good properties and could be a candidate for a yield curve. We are working at Treasury on another approach as well.

The yield curve itself is a very familiar concept. If you look at any standard financial textbook, finance textbook, you will find the yield curve. There is no question about it.

So I think that with regard to the untested concept argument, we do not find that has any validity.

The CHAIRMAN. What is the risk that the yield curve approach would create more volatility in funding and greater uncertainty for plan sponsors?

Mr. SWEETNAM. First off, the current rules have a lot of volatility in funding. That is one of the reasons that people are very worried about the deficit reduction contribution.

What we are looking at is to require more accuracy in the measurement of the liability. Our second step is to relook at the contribution rules. The funny thing is that you are always going to have this volatility in your funding requirements. The question is how much risk do you want to take? Some people could take hedging strategies in their asset mix, so that they do not have that volatility, or they could lessen that volatility. So that there are ways that a corporation can look and reduce some of that volatility.

The fact right now that these smoothing techniques, really you are just smoothing the inputs into the contribution, into determining the contribution. You still have volatility.

What we plan to do in our funding proposal is really look at the outputs to see whether there is a way that we can reduce the volatility there in the outputs rather than reduce—have this smoothing in the inputs.

The CHAIRMAN. Barbara, Steve, Mark and Bill, thank you all very much for being with us today and testifying. I think it is extremely valuable that we build a record on this, that we lift the level of visibility of the issue to the Congress and hopefully this will help urge us along to do some short-term and what is obvious here today and has been obvious for sometime, long-term structural fixes in the situation. Thank you all.

Let me now invite our second and last panel up to the table, if you would please.

To all of you again, thank you very much. Let me introduce our second panel. Scott Macey, Senior Vice President of Aon Consulting who is testifying here on behalf of industry. David John, Research Fellow at the Heritage Foundation. Melvin Schmeiser, a retired steelworker from Baltimore, MD, whose pension was recently placed in receivership by the Pension Benefit Guarantee Corporation.

Scott, we will start with you. Please proceed.

STATEMENT OF SCOTT MACEY, SENIOR VICE PRESIDENT, AON CONSULTING, SOMERSET, NJ

Mr. MACEY. Mr. Chairman, thank you for the opportunity to appear before the committee today. As mentioned, my name is Scott Macey. I am Senior Vice President of Aon Consulting and I am the former chairman of the ERISA Industry Committee and remain on its board. I am serving today as a spokesperson for six prominent business organizations that represent a broad cross-section of American business.

These organizations come before you with a single voice to emphasize the need to preserve our Nation's voluntary employer-sponsored defined benefit system.

Our defined benefit system stands at a crossroads and I think that has been indicated by the prior witnesses this morning. Congress confronts a fundamental choice whether to continue down the current road of a somewhat inflexible funding and regulatory regime that is often illogical and imposes untenable burdens or whether to chart a new path toward a vibrant and growing defined benefit system.

Defined benefit plans and the employers that voluntarily sponsor them confront unprecedented burdens. Some are caused by temporary economic conditions but others are caused by arcane, obsolete, and excessive Government regulation. A case in point is the requirement that pension funding and related obligations be calculated using the defunct 30-year treasury securities rate that artificially inflates plan liabilities and required contributions.

This defunct interest rate and the uncertainty as to what will replace it is layered on top of counterproductive and inflexible funding rules, widespread exposure to unwarranted litigation, an environment that is hostile to the type of adaptation that is necessary if defined benefit plans are to survive in the 21st century, and a difficult market and interest rate environment.

Action to strengthen the defined benefit system should be taken now, beginning with Congress promptly replacing the obsolete 30-year treasury rate. We have heard the Government support of re-

placing that with a 30-year corporate rate this morning and we agree with that aspect of their testimony.

The result of using the 30-year treasury rate is that pension liabilities are inflated and employers are required to make excessive contributions and PBGC variable-rate premiums. Perhaps more than any other factor, these inflated and uncertain financial obligations imposed on employers have contributed to the spate of recent plan freezes and terminations. We urge the Senate to act now and join the House in passing legislation adopting a corporate bond rate replacement for the defunct 30-year treasury rate. Senator Gregg has introduced a bill, S. 1550, to do just that.

Unfortunately, the Treasury Department has also suggested another element ultimately moving to a formula based on a spot rate yield curve. Such a yield curve concept would mark a major change to a volatile and complicated regime under which the interest rates used would be based on immediate spot rates and vary with the demographics of plan participants.

A yield curve, however, would add only a veneer of accuracy while imposing complexity, volatility, and unpredictability to pension funding. We believe that a yield curve would have an adverse impact on the health of the defined benefit system and certainly should be rejected without a great deal of further study.

I would like to take a few moments just to address a couple of other issues. The PBGC is supported by plan sponsors and provides critical backup benefit security enjoyed by millions of plan participants. While the PBGC's current deficit situation should be evaluated and monitored, as it is, we believe that the long-term financial position of the agency is strong. The current deficit is not a threat to the PBGC's viability and it would be a mistake to act precipitously at this time.

Indeed, the PBGC has operated at a deficit position most of the time throughout its long history. Today the agency has over \$25 billion in assets and by its own statements can pay benefits for many years into the future.

One rare source of vitality in recent years within our defined benefit system has been hybrid pension plans. Hybrid plans respond to changing work patterns and workforce demographics and include the many features in defined benefit plans that make these plans popular with employees.

Pending at the relevant Federal regulatory agencies are several projects to provide much needed guidance on hybrid pension plans and issues related to them. However, some in Congress, and the House has already done this, have attempted to use the current appropriations process to deny funding for these regulatory projects. Any such efforts to foreclose agency guidance that might arise in the Senate should be rejected as harmful to the retirement system and the retirement security of millions of Americans.

The policy decisions that Congress makes in the near future could tip the balance one way or the other toward a vibrant retirement system that continues to offer employers and employees choices between defined benefit and defined contribution plans or toward a more narrow system in which defined contribution plans are the only retirement vehicle available to most workers.

We stand ready to work with Congress and the Administration to find solutions to strengthen and preserve our defined benefit pension system and protect American workers. Most critically today, we urge Congress to act now to adopt the suggested corporate rate interest proposal and to also act to protect and encourage hybrid pension plans.

We appreciate the opportunity to testify. Obviously we would be happy to respond to any questions.

[The prepared statement of Mr. Macey follows:]

99

TESTIMONY OF SCOTT MACEY

ON BEHALF OF THE

AMERICAN BENEFITS COUNCIL

BUSINESS ROUNDTABLE

ERISA INDUSTRY COMMITTEE

FINANCIAL EXECUTIVES INTERNATIONAL

NATIONAL ASSOCIATION OF MANUFACTURE

AND

US CHAMBER OF COMMERCE

BEFORE A HEARING OF THE

UNITED STATES SENATE

SPECIAL COMMITTEE ON AGING

ON

AMERICA'S PENSION SYSTEM

OCTOBER 14, 2003

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear before this Committee. My name is Scott Macey, and I am Senior Vice President of Aon Consulting. Today, I am serving as a spokesman for the American Benefits Council, the Business Roundtable, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers, and the US Chamber of Commerce – organizations that represent a broad cross-section of American business. These organizations come before you with a single voice to emphasize the need to preserve our nation's voluntary, employer-sponsored defined benefit system.

Defined benefit plans and the employers that voluntarily sponsor them confront unprecedented burdens – some caused by temporary economic conditions, but others caused by arcane, obsolete, and excessive government regulations. A case in point is the requirement that pension funding and related obligations be calculated using the defunct 30-year Treasury securities rate that artificially inflates required contributions. This defunct interest rate (and the uncertainty as to what will replace it) is layered on top of counter-productive and inflexible funding rules, widespread exposure to unwarranted litigation, and an environment that is hostile to the type of adaptation that is necessary if defined benefit plans are to survive in the 21st Century. Moreover, all this is occurring at the same time that defined benefit plans face an unprecedented combination of low interest rates, stock market declines, and an economy struggling to grow.

Our defined benefit pension system stands at a crossroads. Congress confronts a fundamental choice – whether to continue down the current road of an inflexible funding and regulatory regime that is illogical and imposes untenable burdens or whether to chart a new path toward a vibrant and growing defined benefit system.

Given all these pressures, it should come as no surprise that employers are increasingly abandoning defined benefit pensions, leaving open the question of whether defined benefit plans will continue to be available to American families on a wide-spread basis in the future. Fortunately, many of the challenges facing the system can be addressed in a positive manner that will enable employers to continue providing financially sound pension programs to their

employees. But action to strengthen the defined benefit system must be taken now – beginning with Congress promptly replacing the obsolete 30-year Treasury rate.

At the same time, it is critical that Congress not overreact to temporary conditions by rushing to enact major reforms (such as the recently floated “yield curve” concept) that have not been adequately analyzed. Our pension statutes are complex and interrelated, and reform should not be adopted on a piecemeal basis. Pension changes can have dramatic effects on plans, employers, and employees – as well as on equity and bond markets and the economy as a whole. Reforms should be considered carefully, with due consideration for their likely impact, and be based on comprehensive analysis. In evaluating changes, Congress must remember that tens of millions of American workers and retirees rely on defined benefit plans as a critical element of their retirement security. We owe it to those Americans and their families to ensure that changes, no matter how well intentioned, are not counter-productive.

The policy decisions that Congress makes in the near future could tip the balance one way or the other – toward a vibrant retirement system that continues to offer employers and individuals realistic options under both defined benefit and defined contribution plan designs or toward a more narrow system in which defined contribution plans are the only retirement plan available to most workers. In evaluating any proposals, it is critical to recognize that the U.S. pension system is voluntary. Employers are not required to offer employees a retirement plan. And most importantly, although these plans no doubt benefit companies in attracting, retaining, and rewarding employees, the overwhelming beneficiaries of the defined benefit system are American workers and their families. To create a robust system, the government must make it clear to employers that it supports their sponsorship of retirement plans – including defined benefit plans. Congress and the Executive Branch can show the necessary support for the retirement system through their own public statements, by providing clear guidance to employers on how to start and maintain plans, and most importantly by formulating laws that provide a clear, flexible, and responsive framework. Defined benefit plans have suffered for years from a regulatory regime that on the one hand is overwhelmingly detailed, complex, and inflexible and on the other hand fails to provide the necessary structure or support for new plan designs such as hybrid plans.

We stand ready to work – together with Congress and the Administration – to find solutions to strengthen and preserve defined benefit pension plans and protect American workers, and urge the members of this Committee and Congress to consider the following key points.

- The obsolete 30-year Treasury rate that is required to be used for pension calculations should be replaced immediately with a rate based on a composite blend of the yields on high-quality corporate bonds
- The defined benefit system provides hundreds of billions of dollars of retirement income to millions of Americans. Proposed changes to the defined benefit system should be adopted only after careful review and analysis, including input from plan sponsors and participants. .
- Policymakers should not make the mistake of assuming that the recent business cycle indicates a need for wholesale reform of the pension funding rules.
- Some modest modifications to the current funding regime (e.g., increasing the tax-deductibility of pension contributions, elimination of rules that contribute to funding volatility) should be considered to increase its effectiveness.
- Requiring use of a spot-rate yield curve (as proposed by the Treasury Department and adopted by the Senate Finance Committee) would involve a significant change in our pension system to a volatile and complicated regime, and should not be adopted.
- It is important that any new disclosure requirements be responsible and serve a clearly defined need, and that any misleading or duplicative disclosure requirements be rejected.
- While the Pension Benefit Guaranty Corporation's (PBGC) deficit should be evaluated and monitored, the long-term financial position of the PBGC is strong, and analogies to the savings and loan (S&L) crisis are misplaced. More informative measures of the PBGC's solvency should be developed and publicized.
- Congress should not prevent the Treasury Department and IRS from resolving outstanding legal issues involving hybrid pension plans.

Background on Defined Benefit Plans – Defined benefit plans offer a number of features critical for employees' retirement security.

- Benefits are funded by the employer (and do not typically depend upon employees making their own contributions to the plan).
- Employers bear the investment risk in ensuring that earned benefits are paid.
- Benefits are guaranteed by the federal government through the plan sponsor-funded PBGC.
- Benefits are offered in the form of a life annuity that assures participants and their spouses who elect this form of payment will not outlive their retirement income.

The stock market conditions of recent years (and the corresponding decline in many individuals' 401(k) balances) have once again demonstrated to many the important role that defined benefit plans can play in an overall retirement strategy.

As of 1998 (the most recent year for which official Department of Labor statistics exist), approximately 42 million Americans were participants in defined benefit pension plans.¹ In that year alone, more than 18 million retirees received benefits from defined benefit plans totaling over \$111 billion (almost half of all benefits received from private-sector, employment-based retirement plans).² Without these hundreds of billions of dollars in benefits, fewer American families would be able to achieve a secure retirement. Yet while the defined benefit system helps millions of Americans achieve retirement income security, it is a system in which fewer and fewer employers are encouraged to participate because of deficient public policy provisions. The total number of government-insured defined benefit plans has decreased from approximately 114,500 in 1985 to fewer than 33,000 such plans in 2002.³ Looking at this decline over just the past several years makes this downward trend all the more stark. From 1999 through 2002, there has been a decrease of over 7,500 defined benefit plans – from 39,882 to 32,321 plans – or 19 percent in just three years.

Even more disheartening, the statistics quoted above do not even take into account pension plans that have been frozen by employers (rather than terminated), an event that, like termination, results in no new pension benefits for existing employees and no pension benefits whatsoever for new hires. If frozen plans were tracked (and they clearly have been on the increase in recent months), the decline of our nation's defined benefit pension system would be even more

¹ U.S. Census Bureau, Statistical Abstract of the United States: 2002, No. 524.

² U.S. Census Bureau, Statistical Abstract of the United States: 2002, No. 524.

³ 2002 PBGC Annual Report, page 13.

apparent. And unfortunately, there are virtually no examples of frozen plans “thawing out” such that benefits begin to accrue once again. Once the plans are frozen, employees accrue no further benefits. Of course, these facts are sobering from both a human and policy perspective.

Pension Plan Funding Generally – Pensions are a long-term commitment. They are both funded and disbursed over decades. Recently, concerns have been raised about the funded status of many defined benefit plans. Much of the deterioration in pension funding that we see today is attributable to the current unique combination of historically low interest rates and historically depressed asset values. Also, the mandated use of the artificially low interest rate on 30-year Treasury bonds, that are no longer even issued by the Treasury Department, which I will discuss in more detail below, artificially inflates liabilities, and consequently makes a plan’s funding level seem lower than it really is when viewed in the proper perspective of a long-term commitment.

Policymakers should not make the mistake of assuming that the recent business cycle indicates a need for wholesale reform of the pension funding rules. It does not. Recent market and interest rate conditions should be expected to produce temporary funding deficiencies that will correct as conditions improve and once Congress replaces the obsolete 30-year Treasury rate. We have, in fact, seen the beginning of such corrections over the past few months. In fact, it would be an anomalous situation if there was not a downturn in funding of typical pension plans during periods of general economic downturn coupled with low interest rates.

It is also important to note that the swing from the abundant pension funding levels of the 1990’s to the present state of deficits for many plans has been exacerbated by the counterproductive pension funding rules adopted over the last few decades. Beginning in the 1980’s, defined benefit plans were subjected to layer upon layer of ill-advised laws and burdensome regulation, often overlapping and sometimes contradictory and too often enacted as a means of raising federal revenue. These changes included limits on the ability of companies to contribute to their plans by lowering the maximum deductible contribution, imposing a significant excise tax on nondeductible contributions, and placing heavy penalties on withdrawals of surplus assets. In 1997 and after, some limited relief was provided, but the overall result is that our laws and

regulations strongly encourage employers to keep their plans as near as possible to the minimum funding level instead of providing a healthy financial cushion above that level. While hasty and radical reform would be unwise, some modest modifications to the current funding rules could be considered to increase their effectiveness without impairing the attractiveness of defined benefit plans to employers. Such modifications could include increasing the tax-deductibility of pension contributions to encourage financial cushions in plans and elimination of rules that exacerbate the volatility of required pension contributions to protect against economic downturns.

Replacement of the Obsolete 30-Year Treasury Rate – The need to replace the obsolete 30-year Treasury rate used for pension calculations is the most pressing issue facing the defined benefit pension system today, and cries out for immediate resolution. Prompt action is required to correct the problem in order to prevent a further exodus of employers from the defined benefit system.

Under current law, employers that sponsor defined benefit pensions are required to use the 30-year Treasury rate for a variety of pension calculation purposes, including plan funding requirements, calculation of lump sum distributions, and liability for variable premium payments to the PBGC. The various provisions of federal law requiring use of the 30-year Treasury rate for pension calculations were enacted in 1987 and 1994 when there was a robust market in 30-year Treasury bonds and the yields on those bonds were thought to be an acceptable proxy for other long-term investments. While a variety of rates were discussed when the 30-year Treasury rate was first selected in 1987, it was believed at the time that it reflected the appropriate benchmark whereby companies could reasonably set aside appropriate assets to meet their long-term funding obligations. That assumption is no longer valid.

In 1998, the U.S. Treasury Department began retiring federal debt by buying back 30-year Treasury bonds. In October 2001, the Treasury Department discontinued issuance of 30-year bonds altogether. With commencement of the buyback program, yields on 30-year Treasury bonds began to drop and to diverge from the rest of the long-term bond market – a divergence that increased precipitously after the October 2001 discontinuation. As a result of the shrinking

supply of these bonds (particularly when coupled with continuing demand for the relative safety of U.S. government debt), the interest rate on existing 30-year Treasury bonds has reached historic lows and no longer correlates with the rates on other debt instruments. In testimony before Congress, Bush Administration officials have stated that, “[The] Treasury Department does not believe that using the 30-year Treasury bond rate produces an accurate measurement of pension liabilities.”⁴

The result is that pension liabilities are inflated, and employers are required to make excessive pension contributions (often three or four times what was anticipated) and PBGC variable rate premium payments. Perhaps more than any other factor, these inflated and uncertain financial obligations imposed on employers have contributed to the spate of plan freezes and terminations in recent years.

Today’s inflated funding requirements harm the economy and have a direct adverse impact on many workers since cash inappropriately mandated into pension plans diverts precious resources from investments that create jobs and contribute to economic growth. Facing pension contributions many times greater than they had reasonably anticipated, employers are having to defer steps such as hiring new workers, investing in job training, building new plants, and pursuing new research and development. Indeed, some employers may be forced to lay off employees in order to finance the required cash contributions to their pension plans. Moreover, financial analysts and financial markets are now penalizing companies with defined benefit pension plans because of the unpredictable future pension liabilities that result from uncertainty as to what will replace the 30-year Treasury rate. The resulting pressure on credit ratings and drag on stock prices, which harms not only the company but also its shareholders, is a further impediment to strong economic growth.

Due to these problems and the fact that use of an obsolete interest rate for pension calculations makes no sense from a policy perspective, Congress provided in the March 2002 economic stimulus act a temporary interest rate adjustment that expires at the end of this year. Since 2002,

⁴ Testimony of Peter Fisher, Undersecretary for Domestic Finance, U.S. Department of Treasury, before the House Ways and Means Subcommittee on Select Revenue Measures (April 30, 2003).

the 30-year Treasury rate has only become progressively more obsolete, and the associated problems described above have become more grave. In short, the 30-year Treasury rate is an obsolete rate that must be replaced.

We strongly urge that Congress replace the defunct 30-year Treasury rate for pension calculations with a rate based on a composite blend of the yields on high-quality corporate bonds. A corporate bond blend steers a conservative course that fairly and appropriately measures pension liabilities. High-quality corporate bond rates are known and understood in the marketplace, and are not subject to manipulation. A benchmark based on such rates would also provide the predictability necessary for a company to plan its pension costs and the role such costs play in their business.

Use of such a conservative corporate bond blend would also ensure that plans are funded responsibly. The strict funding requirements that Congress adopted in 1987 and 1994 would continue to apply. Substitution of a corporate bond blend would merely mean that companies are not forced to make the extra, artificially inflated contributions required by the obsolete 30-year Treasury rate. Thus, stakeholders from across the ideological spectrum – from business to organized labor – agree that the 30-year Treasury rate should be replaced by a conservative, high-quality corporate bond blend.

Senator Judd Gregg, Chairman of the Health, Education, Labor, & Pensions (HELP) Committee, has introduced a bill (S. 1550) that replaces the obsolete 30-year Treasury rate with a corporate bond blend for five years. We urge members of this Committee to co-sponsor S. 1550, and we recommend that the Senate promptly pass legislation that adopts a corporate bond blend beginning in 2004. Action as soon as possible is imperative. The House has already overwhelmingly passed a bill (H.R. 3108) by a vote of 397-2 providing for the use of a blend of high-grade corporate bond indices as the benchmark for funding plans for the next two years.

Other Proposals Affecting Defined Benefit Plans – Recently, a wide range of proposals have surfaced that are ostensibly designed to improve the defined benefit system. In our view, many of these proposals have not been sufficiently analyzed and could well further disincen-

employers from establishing and maintaining defined benefit plans. We believe that if defined benefit pension plans are to be a vital component of retirement income security for American workers and their families in the future, the government must act in a thoughtful and helpful manner to create an environment that encourages rather than discourages responsible participation in the retirement system. Toward that end, the legislative and regulatory environment governing defined benefit plans should be transformed from one that is incomprehensible, volatile, and self-defeating to one that is understandable, predictable, and effective. The current forbidding and inhospitable environment – which discourages employers from establishing and preserving defined benefit plans – should be reformed to encourage the formation and continuation of these plans. However, as I have previously stated, any changes should be adopted only after careful review and analysis, including input from plan sponsors and participants and an understanding of the behavioral reactions that will occur among major stakeholders.

With these general observations in mind, let me briefly address concerns we have with respect to certain proposals that have been made.

Yield Curve – The Treasury Department has put forward a proposal to ultimately replace the 30-year Treasury rate with a so-called “yield curve” concept that raises a large number of serious concerns. Under this proposal, the interest rate used would, in effect, change based on a sliding scale yet to be constructed by the Treasury Department and based on an analysis of a spot-rate yield on corporate bonds of different durations. The Senate Finance Committee adopted a similar approach when it reported the National Employee Savings and Trust Equity Guarantee Act, a pension reform bill, on September 17, 2003.

Requiring use of a spot-rate yield curve would involve a significant change in our pension system to a volatile and complicated regime under which the interest rates used for measuring pension liability would be based on immediate spot rates and would vary with the schedule and duration of payments due to each plan’s participants. The current law rules that allow employers to use the average of the relevant interest rate over several years to reduce funding volatility would be repealed. In addition, important flexibility would be lost by removing the existing

interest rate “corridor” that allows employers to use a range of the averaged 30-year Treasury rate for pension calculation. This corridor has historically been 90% to 105% of the averaged rate.

Although both Congress and we lack sufficient detail to fully analyze the yield curve approach, it raises a large number of policy concerns and unanswered questions. In fact, the entire yield curve concept seems to be based on an incorrect assumption that such an approach would add significant accuracy and precision to pension funding. In reality, a yield curve would seem to add only a veneer of accuracy while truly imposing complexity, volatility, and unpredictability to pension funding. Based on our current understanding of the concept, we are concerned that the yield curve would:

- ***Exacerbate funding volatility*** by subjecting pension liability calculations not only on fluctuations in interest rates, but also to changes in the shape of the yield curve (caused when rates on bonds of different durations move independent of one another) and to changes in the duration of plan liabilities (which can occur as a result of layoffs, acquisitions, etc.). As mentioned above, use of the average of the relevant interest rate over several years (as under current law) also would not be allowed.
- ***Increase pension plan complexity*** (already a significant impediment to defined benefit plan sponsorship) by moving from a system based on a single interest rate to a much more complex system that relies on a multiplicity of instruments with widely differing durations and rates. Although statements have been made that the yield curve adjustment would be simple and easy, the fact that the Treasury Department has failed to provide full details on the proposal, even after months of study, belies the simplicity of the proposal.
- ***Make it difficult for employers to plan and predict their pension funding obligations*** (another significant impediment to defined benefit plan sponsorship today) due to the increased volatility and complexity described above.
- ***Result in less ability for a plan sponsor to fund pension plans*** while participants are younger because it would delay the ability to deduct contributions to periods when the workforce is more mature. As mentioned above, the corridor surrounding the interest rate

also would be eliminated. The resulting loss of flexibility would make it harder for employers to fund their plans in times when corporate resources are more plentiful.

- ***Require use of bonds of durations with very thin markets*** (because few such bonds are being issued). As a result, single events (e.g., the bankruptcy of a single company unrelated to the employer sponsoring the pension) could affect the rate of a given bond index dramatically, thereby leading to distortions in pension calculations and even potential manipulation.
- ***Involve a considerable delegation of policy authority*** by Congress to the Executive Branch since the entirety of the construction and application of the yield curve would apparently be left to the regulatory process. The construction of the required yield curve would not be a transparent process or one easily understood by plan sponsors or monitored by Congress. Many judgments would have to be made regarding the appropriate bonds to be used to set the rate at each duration, including where available bonds of a particular duration provide widely varying rates of return.
- ***Influence the hiring and retention patterns of employers that sponsor defined benefit plans*** since some employees would be much more costly than others.
- ***Result in, at best, only a marginally more accurate measure of liabilities*** compared with the use of a corporate bond rate which represents a conservative middle course between the long-term rates of return actually earned by pension plans and the annuity rates charged by insurers to terminating plans. Pension plans are not like bank accounts or certificates of deposit, and should not be evaluated as if they are demand deposit-like obligations, rather than the long-term commitments that they are.

There are many additional unanswered questions created by the yield curve concept. For example, it is unclear how such a concept would apply to issues such as the calculation of lump sums, the valuation of contingent forms of distribution, the payment of interest on – and conversion to annuity values of – employee contributions to defined benefit plans, the payment of interest credits under hybrid pension plans, and the calculation of PBGC variable premium obligations.

It is unrealistic to believe that all of these outstanding issues and concerns raised by the yield curve concept could be addressed in the short time in which Congress must act on a replacement for the 30-year Treasury rate. Even the Treasury Department (which originally floated the yield curve concept) recognizes that such an untested change would require a complete reevaluation of our pension funding rules. In addition, it is unclear from the limited information available how the very significant issues of transitioning from a system based on corridors and averaging to a less flexible yield curve system would be resolved. At a minimum, to the extent that this type of major overhaul of our pension funding rules is considered, it should be done in the context of a more fundamental and thoughtful review through deliberative Congressional study and the regular legislative process. This type of more fundamental review would be possible if Senator Gregg's pension rate replacement legislation (S. 1550) is enacted since it replaces the 30-year Treasury rate only through 2008. This window of time would allow Congress to decide whether additional changes are warranted.

Proposals Regarding Disclosure and Other Requirements for Certain Plans – The Bush Administration has also made proposals that would require additional disclosure of pension information and that would mandate freezes in certain private-sector pension plans. First, while we certainly support the goal of transparency of pension information, it is important that any required disclosure be responsible and serve a clearly defined need. Disclosure that provides a misleading picture of pension plan finances or that is unnecessary or duplicative of other disclosures is counter-productive. For example, the Administration's proposal to key disclosure off of a plan's termination liability (which is generally overstated) could provide a misleading depiction of plan finances for ongoing plans that are reasonably well-funded because these plans are not in any danger of terminating. This type of misleading disclosure could unnecessarily and falsely alarm plan participants, financial markets, and shareholders. Similarly, the Administration's proposal to allow publication of certain information that today is provided on a strictly confidential basis to the PBGC whenever a plan is underfunded by more than \$50 million would provide yet another impediment to companies' willingness to sponsor defined benefit plans, and ignores the size of the plan and its assets and liabilities. For many pension plans with billions of dollars in assets and obligations, such a relatively modest amount of underfunding is quite normal and appropriate. It should not be cause to trigger publication of private corporate

information on an ad hoc basis that would sound inappropriate alarm bells the actual impact of which would be to deter companies from maintaining defined benefit plans.

We also believe that the Administration's proposal that would freeze private-sector pension plans and remove lump sum rights when a company reaches a certain level of underfunding and receives a junk bond credit rating requires careful review. While we appreciate (and share) the Administration's concerns about PBGC guarantees of benefit promises that are made by financially troubled companies, this proposal raises technical and policy issues that require further examination. For example, the Administration's proposal provides no definition of "junk bond" status. In addition, Congress should carefully consider whether it is appropriate to mandate a cutback in participants' benefits based on a third-party's determination of credit rating. Moreover, it is not clear why employees should lose their rights to certain forms of benefit when their company experiences financial trouble.

Financial Status of the PBGC – The PBGC provides critical benefit security enjoyed by the millions of defined benefit plan participants. Businesses that voluntarily maintain retirement plans strongly believe that the PBGC should be operated and maintained on a sound financial basis, not only because it protects participants and retirees, but also because these businesses pay the premiums that support the PBGC.

Nonetheless, while the PBGC's deficit should be evaluated and monitored, we believe that the long-term financial position of the PBGC is strong. The current deficit is not a threat to the PBGC's viability, and it would be a mistake to be alarmed and overreact. Indeed, the PBGC has operated in a deficit position throughout most of its history. Nor does the shift from surplus to deficit over the course of one year suggest the need for an immediate change in the pension funding or premium rules in order to safeguard the health of the PBGC. Today, the PBGC's single-employer program has total assets in excess of \$25 billion, and it earns money from investments on those assets.⁵ While the PBGC currently reports liabilities of approximately \$29 billion for its single-employer program, the annuity pension obligations underlying those

⁵ PBGC 2002 Annual Report, page 30.

liabilities come due over many decades,⁶ during which time the PBGC can be expected to experience investment gains to offset any “paper” deficit that exists today. It should also be noted that these liability projections by the PBGC are based on unrealistic interest rate and mortality assumptions, which make liabilities appear larger than they actually are.

It is also important to remember that when the PBGC takes over a plan, it assumes all of the plan’s assets, but not all of its liabilities. Instead, the PBGC insures a maximum guaranteed normal retirement age benefit for each participant (\$43,977 for 2003). While this limits the benefits of some pensioners, it also serves to limit the maximum exposure of the PBGC. In addition, the PBGC gains control of the assets at the time of termination, but will pay benefits only over subsequent decades. The substantial assets that the PBGC holds and the relatively modest size of its deficit when viewed in the context of its capped and long-term liabilities ensures that the PBGC will remain solvent far into the future even under current rules and economic conditions – a point that the PBGC itself has acknowledged repeatedly.

As the title of this hearing suggests, some have attempted to draw an analogy between the PBGC’s financial condition and the savings and loan (S&L) crisis. We believe that such comments misapprehend the actual circumstances faced by the agency. Most important, as just discussed, the PBGC’s long-term financial position is strong. In addition, the downward spiral of S&Ls making riskier and riskier investments in an attempt to remain competitive is completely inapplicable given the PBGC statutory mandate to prudently manage its assets and its insulation from competition. Moreover, the PBGC is an entirely different entity than an S&L guarantor. Perhaps most significantly, S&L depositors had the ability to demand the full amount of their deposits at any time, raising a genuine risk of lack of sufficient funds and creating a fertile ground for financial panic. When assets were insufficient to meet consumer demand for deposits, the government was forced to step in and make up the difference. In contrast, the PBGC is only required to pay benefits as they become due, and those insured by the PBGC have no right to demand their full benefits at any time. As a result, there is no comparable immediate risk to the government of having to step in to compensate for insufficient funds.

⁶ The PBGC does not make lump sum payments even if the terminated plan provided for such payments.

At this point in time, we do not believe that the PBGC's finances should be cause for alarm. In times of economic hardship, more pension plans (and the companies that sponsor them) confront economic difficulty (including bankruptcy), more pension plans suffer declines in asset values, and more pension liabilities are assumed by the PBGC. At the same time, the PBGC may enjoy sub-par investment gains on its assets. As the economy improves, this cycle reverses itself, returning the PBGC to robust financial health.

Moreover, we believe that more informative measures of the PBGC's solvency should be developed and publicized. For example, in presenting its financials, the PBGC should place greater emphasis on its long-term ability to pay benefits as well as on average claims over time; it should use a more realistic discount rate in calculating its liabilities consistent with long-term return expectations; and it should develop a transparent and consistent mechanism for reporting "probable" and "possible" terminations.

Threats Facing Hybrid Pension Plans – One rare source of vitality in recent years within our defined benefit system has been hybrid pension plans (such as cash balance and pension equity). Hybrid plans were developed in part to correct a mismatch between the traditional pension design and the needs of today's mobile workers. The traditional pension design disproportionately awards benefits to employees with very long service relative to employees with less than career-long employment at their firm. Today, however, most employees change jobs frequently. Indeed, numerous studies show that, in our mobile workforce, the more even benefit accrual formula of hybrid pension plans delivers higher benefits to the vast majority of workers. At the same time, hybrid plans include the features that make traditional defined benefit pension plans popular with employees – namely, an insured, employer-funded benefit with lifetime annuity distribution options for which the employer bears the investment risk. Today, according to the PBGC, there are more than 1,200 hybrid pension plans in the U.S., covering more than 7 million employees.

While these plans offer a ray of hope for the future of our defined benefit system, hybrid plans also face serious threats that, if not addressed, will lead to their extinction. An overriding problem for these plans is that the rules applicable to defined benefit plans are stuck in the past,

and have not been updated to reflect the development and adoption of hybrid pension plans. The result of these outdated rules is that a number of pressing compliance issues regarding hybrid plans have been left unresolved.

Pending at the relevant federal regulatory agencies are several projects to provide much-needed guidance on these issues, such as the proper calculation of benefits in cash balance plans and the proper application of age discrimination standards to hybrid plans. These projects must be completed. However, some who believe that traditional defined benefit plans are the only type of pension design that should be allowed for certain employees have attempted to use the current appropriations process to deny funding for these regulatory projects. In particular, some in the House have used the Transportation-Treasury appropriations bill (H.R. 2989) as a vehicle to express concern about controversies involving isolated cash balance plan conversions, but have done so by seeking to deny Treasury funding to complete pending regulatory projects on hybrid plans.⁷ Any such efforts that might arise in the Senate to affect complex pension policy through the appropriations process should be rejected. If the Treasury Department and IRS are prevented from resolving the outstanding legal issues involving hybrid pension plans, the resulting uncertainty will lead many employers to abandon these plans so that fewer Americans have pension coverage.

We are also concerned about legislative proposals (such as those embodied in S. 825 from Senator Tom Harkin) that would mandate that employers converting a traditional defined benefit plan to a hybrid pension plan allow employees to elect at retirement whether they wish to receive the hybrid pension plan benefit or a benefit under the traditional defined benefit plan in place at the time of the conversion. Our voluntary pension system is premised on the idea embodied in current law that benefits already earned are absolutely protected (the “anti-cutback” rule) but that employers have flexibility to adjust to changing circumstances by increasing or decreasing benefits that will be earned in the future. Under the mandated choice legislation, however,

⁷ These efforts, led by Representative Bernie Sanders (I-VT), have pointed to a lone federal district court decision in *Cooper v. IBM* (2003 U.S. Dist. LEXIS 13223 (July 31, 2003)) that hybrid pension plans are age discriminatory. The *Cooper* decision is inconsistent with other federal court decisions, contrary to Treasury Department proposed regulations, and not supported by the legislative history or structure of the pension age discrimination statute. Under the decision’s extremely flawed logic, simple compound interest would be illegal in pension plans. Even the Social Security program would be deemed illegal if the *Cooper* decision were applied to it.

businesses would be unable to alter future benefit levels in conjunction with a conversion as employees could simply choose to receive benefits under the prior formula. Yet business circumstances – such as increased international competition, significant workforce change, the presence of competitor firms with lower or no pension expense, possible company bankruptcy, the need to attract new workers, or employee preference for a reallocation of benefit dollars – sometimes necessitate adjustments to pension plans. And, moreover, the mandated choice proposals would add an element of severe uncertainty to pension funding since employers would not be able to ascertain what benefits to fund.

In no other area do we prevent employers from altering employment conditions in such a manner. Employers may cease employing individuals, change pay levels, alter working conditions, revise health coverage, even drop or freeze a pension program. Yet under the mandated choice proposals, employers that adopt a hybrid pension must keep the prior traditional pension forever for current employees. This would radically depart not only from the norms of our voluntary pension system but indeed from basic American workplace principles, forcing prudent businesspeople – who will be unable to make these unalterable benefit commitments – to depart the defined benefit system as quickly as possible. Congress should reject these types of unhelpful mandated choice requirements that may seem to have some superficial appeal in protecting participants but in reality would only result in hurting them.

The cumulative effect of the various assaults on hybrid plans discussed above has been to jeopardize the existence of one of the only viable defined benefit designs that is able to provide meaningful benefits to employees in the economic and business environment of the 21st century. These threats to hybrid pension plans must be removed.

Additional Defined Benefit Issues of Importance – Finally, I want to mention briefly two other policy issues of importance to the defined benefit system.

Making the 2001 Pension Reforms Permanent – The 2001 tax act contained a number of very positive changes to the rules governing defined benefit plans. These included repeal of artificial funding caps, increases in the benefits that can be paid and earned from defined benefit plans,

and simplifications to a number of defined benefit plan regulations. We support making the 2001 retirement savings reforms, which are scheduled to sunset at the end of 2010, permanent so that employees and employers can have the long-term certainty so necessary for pension planning purposes.

Pension Accounting – We are also concerned about ominous developments concerning the accounting standards for pension plans. While the accounting issues are still in flux, we wanted to make the Committee aware of this added source of potential strain on the defined benefit system. Accounting standard-setters, led by those in the United Kingdom, are pushing to require companies to reflect the full fluctuation in pension asset gains and losses on the firm's financial statements *each year*, thereby prohibiting companies from amortizing such results over a period of years as they do under today's accounting standards. This new "mark-to-market" approach is inconsistent with the long-term nature of pension obligations, produces extreme volatility in annual corporate income, and has prompted 75 percent of British pension sponsors to consider terminating their plans. Given the many other challenges faced by sponsors of defined benefit plans, abandonment of current U.S. accounting standards for this "mark-to-market" approach would be devastating.

Conclusion

Thank you, Mr. Chairman, for the opportunity to present the views of the business community on how to maintain a viable and strong pension system. Defined benefit plans offer many unique advantages for employees, and the employers that sponsor these pension plans sincerely believe in their value. Without prompt action by Congress and the Administration, however, these plans will increasingly disappear from the American pension landscape. Working together, we can prevent this tragic result.

I would be pleased to answer whatever questions you may have.

The CHAIRMAN. Scott, thank you for very much. Now let us turn to David John, Research Fellow at the Heritage Foundation. David, welcome before the committee.

STATEMENT OF DAVID JOHN, RESEARCH FELLOW, HERITAGE FOUNDATION, WASHINGTON, DC

Mr. JOHN. Thank you, Mr. Chairman, and thank you for the opportunity to testify. I am David John. I am testifying, frankly, on my own behalf. I am a Research Fellow with the Heritage Foundation specializing in retirement issues, Social Security and similar financial problems at the moment.

What a difference a year makes. Last year about this time, a little bit earlier in the year, the debate was about the risks of defined contribution plans. If you listened to various of the legislators, staffers, and others, the problems at Enron, WorldCom, and various and sundry other made it sound like anyone who supported a defined contribution plan clearly did not understand what was in the best interest of workers.

Now we are seeing that while it is very true that defined contribution plans do have an investment risk, there is at least an equal risk in a defined benefit plan, and we are starting to see now some of a costs and some of the problems that we will face in the future.

Your title, the next S&L crisis, is perhaps a little bit too apt than it should be. About 25 years ago I worked for a Congressman from Georgia by the name of Doug Barnard who retired, I guess, about 1992 to or so. At the time we were looking on legislation dealing with the S&L industry. The S&L industry, we were told, was absolutely essential to American housing and that it was going through some temporary problems but these would be dealt with if Congress would just come up with a little bit of forbearance. What Congress came up with was something called goodwill and the regulatory capital.

The net result worked very well for the short run. S&Ls that had looked like they were about to collapse suddenly ended up with enough assets so that they could actually expand.

Unfortunately, what we were seeing was not a temporary phenomenon but a complete change in the industry and once everything came home, the industry collapsed. This was not the activity of a few S&L crooks, although that was popular to say at the time. This was a fundamental change in economic reality. Because Congress had not acted earlier, because Congress had shown, in this case, a little bit too much forbearance, the net cost to the taxpayer was on the order \$500 billion.

Now we look at the whole question of the defined benefit pension plan. Once again we have an industry that is undergoing a fundamental change. Once again this industry is coming up and asking for shifts in the way that their requirements are calculated. Through a deficit reduction contribution or the elimination of the deficit reduction contribution, they are asking for yet a little bit more forbearance. If Congress does not keep the long-term interests of the taxpayer in mind, Congress may find itself with yet another major funding crisis.

This comes to a question of what to do and what not to do. The discount rate has already been discussed rather extensively. We are very concerned that if Congress simply shifts from the current 30-year treasury rate to a corporate yield curve without doing the yield curve as suggested by Treasury, that we are going to find in the long run a situation where the industry is going to be coming back again and again, and we will see—probably not in the short run but in the next few years—some form of a bailout provision.

We are also seeing the need for enhanced disclosure. As has already been said in the earlier panel, workers do not know what their futures hold. In a defined contribution plan you get a benefit statement that you can look at and you know how much money you have.

Frankly, listening to some of my colleagues at Heritage, who tend to come to me and ask if their future has to do with uttering the phrase do you want to supersize that on a regular basis from looking at some of their investments, they are readily aware of what is going on. Under a defined benefit plan, workers do not have that opportunity and I think that is a very serious question.

Equally, there is a serious problem which is addressed by the Treasury proposal which would restrict the opportunity of pension plans to offer new and enhanced benefits without having the means to pay for them.

Now, I am going to stop there but just let me quickly mention that, as Barbara Bovbjerg already said, what we are discussing today, both in defined benefit and defined contribution plan, affects only about 50 percent of the workforce. If this is not addressed in a comprehensive approach that also looks at Social Security, we are going to be missing the real responsibility that we have not only to ourselves and to people who are slightly older to us, because also to our children who are going to have to pay for our mistakes.

Thank you.

[The prepared statement of Mr. John follows:]



The Heritage Foundation 214 Massachusetts Avenue, N.E. Washington, D.C. 20002-4999 (202) 546-4400

Congressional Testimony

**Testimony before the
Select Committee on Aging
United States Senate**

**America's Pensions: The Next Saving and
Loan Crisis?**

October 14, 2003

**David C. John
Research Fellow
Thomas A. Roe Institute
for Economic Policy Studies**

I appreciate the opportunity to appear before you today to discuss the economic future of America's pension plans. This is an extremely important subject, and I would like to thank both Chairman Craig and Ranking Member Breaux for scheduling this hearing. Let me begin by noting that while I am a Research Fellow in Social Security and Financial Institutions at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation.

What a difference a year makes. Last year, there was a great deal of discussion about the "dangers" of 401k retirement plans and other types of defined contribution plans. Experts warned, with some justification that retirement plans where workers had to invest their money faced investment risks. Many of those same experts and legislators called for a return of the good old days when employees were part of a defined benefit retirement plan. Under those plans, rather than having a retirement benefit based on one's investments, a worker receives a company paid benefit based on his or her length of employment and salary history. In theory, defined benefit plans are paid from a separate fund managed by the company.

Those experts implied that these defined benefit plans had little or no risk. They were wrong. Since then, a number of companies have dropped their defined benefit pension plans as part of a bankruptcy proceeding. Just last week, Weirton Steel became the latest company to try to dump their pension obligations on the taxpayer. Today's witness list also includes both the Pension Benefit Guarantee Corporation and a steel worker whose pension was affected by corporate bankruptcy. It is critical for all of us to remember that this is not just a policy issue, it affects real people's lives in the most direct way at the time when they are likely to be least able to change their circumstances.

Now Congress is debating legislation that would allow companies just a little more time to fund their pension plans. It is also looking a ways to change the regulatory framework so that under funded pension plans look like they have just a bit more in assets. Companies claim that without this help, jobs will be lost and the economy will suffer.

The S&L Crisis: Are We On the Same Track With Pensions?

The title of today's hearing, Americas Pensions: The Next S&L Crisis, could not be more to the point. It also brings back some painful memories. Back in the early 1980's, I worked as Legislative Director to a member of the House Banking Committee, former Rep. Doug Barnard of Georgia, as Congress considered legislation dealing with the early signs of the S&L crisis.

At the time, we were told that the industry was essential to America's economy, and that even though they were beginning to run deficits, all that was needed was a little forbearance. As a result, Congress created a regulatory form of capital called "good will" which allowed S&Ls to count an estimate of their reputations and business relationships

as part of capital. At first, the gimmick worked like a wonder. S&Ls suddenly had not only enough capital to be “healthy” but to expand.

Of course, the net result was that when the industry finally collapsed the expanded S&Ls had lost even more money than they would have if they had been allowed to face economic reality several years earlier. The cost to America’s taxpayers was somewhere around \$500 billion. By showing forbearance, Congress had really just made the problem worse and increased the eventual cost. That example could also apply to America’s pensions.

Currently, 12 percent of the labor force is covered by defined benefit pension plans, while an additional 7 percent is covered by both defined benefit and defined contribution plans. Under a defined benefit plan, a worker is promised a retirement benefit based on a percentage of salary for each year worked or similar measures. While the worker does not have the direct investment risk associated with a 401(k) plan, the benefits depend on whether or not the plan is fully funded. The risk that it is not fully funded can be as great or greater than the risk from stock and bond investments, but it is usually much harder for the worker to determine how high that risk is.

A Proper Discount Rate for Defined Benefit Pension Plans.

A key question is whether the pension plan's level of funding is being measured properly. A July 8 proposal by the U.S. Department of the Treasury addresses both the proper way to measure pension plan funding and ways to make it easier for workers and others to determine whether their company's pension plan is at risk. It also proposes ways to prevent companies that are in financial trouble from making promises to their workers and then making the taxpayers pay for them.

The Treasury Department's plan is far superior to the discount rate provisions in the July 18 version of the Portman-Cardin bill passed by the House Ways and Means Committee--H.R.1776, named for the bill's two principal sponsors, Representatives Rob Portman (R-OH) and Benjamin L. Cardin (D-MD)--and Congress should consider incorporating Treasury's proposed reforms into the final bill.

Why an Appropriate Discount Rate Is Important

The funding of a defined benefit pension plan is measured using a “discount rate.” A plan is assumed to be fully funded if the assets that it currently has can be expected to grow at a certain interest rate until the resulting level of assets then equals the total amount of pension payments that the plan promises to make in the future. For example, if a fund will owe \$1,000 in 30 years and assumes that its assets will earn an average of 5 percent every year after inflation, it must have \$231 today in order to be fully funded. (Invested at a 5 percent interest rate, \$231 will grow to \$1,000 in 30 years.)

The discount (interest) rate used to measure a plan's funding is crucial. If a plan assumes that its assets will grow at 7 percent a year instead of 5 percent, it needs only

\$131 today to be fully funded (rather than the \$231 it would need if it used a 5 percent rate). On the other hand, if a plan uses a discount rate of only 3 percent, then it must have \$412 on hand today to be fully funded.

The discount rate has no actual relationship to how much a pension plan's investments are earning. While the law requires that plans make prudent investments, these investments can change over time and are greatly affected by short-term swings in the stock, bond, and property markets. The discount rate is intended to measure whether or not the plan has sufficient assets to meet its obligations over a long period of time; thus, a defined benefit plan uses the rate for long-term government or corporate bonds instead of the rate of interest the plan is earning on its investments.

From 1987 to 2002, the law required that defined benefit pension plans use a weighted four-year average of the returns of the 30-year U.S. Treasury bond rate as their discount rate for determining funding adequacy. Under the 1987 law, plans were allowed to use any number between 90 percent and 105 percent of that rate. The spread between 90 percent and 105 percent was intended to allow the pension plan a slight amount of flexibility in its calculations. This discount rate is also used to determine lump-sum benefits for workers who want a one-time payment instead of a monthly check.

However, using this rate presents two problems. First, the Treasury Department announced in 2001 that it would stop issuing the 30-year Treasury bond. As a result, market prices for these bonds are distorted by the realization that they will no longer be issued. Second, interest rates in general are at a historic low, reaching levels not seen for almost 50 years. While economists expect them to rise gradually, pension plans argue that using today's low rate would make pension plans look far more underfunded than they actually are. Continued use of today's rate would force companies to assign pension plans literally billions of dollars that could be used more effectively to build the company.

Recognizing that the old discount rate was too low, in 2002, Congress allowed pension plans to use instead a number equal to 120 percent of the four-year average of the 30-year Treasury bond rate. However, this law expires after 2003. Some corporations have proposed that Congress substitute a longer-term corporate bond rate for the 30-year Treasury rate. Since corporate bonds do not have the full faith and credit of the United States behind them, they have higher interest rates. Using those higher interest rates would sharply reduce the amount of money that a pension plan must have on hand in order to avoid being underfunded while still protecting the funding status of the plan.

How the Treasury Department Proposal Would Affect the Discount Rate

On July 8, the Treasury Department proposed that a two-stage change in the pension plan discount rate be substituted for the current 30-year Treasury bond rate. For the next two years, the Treasury proposal would allow plans to use Congress's choice of either the 20-year or 30-year corporate bond rate. After that two-year period, companies

would begin a three-year transition to using a corporate bond interest rate determined by the average age of an individual company's workforce.

Since companies with older workers will begin to pay out pension benefits sooner than companies with younger workers, the Treasury Department proposal would require companies with older workers to use a shorter-term corporate bond rate. Short-term bonds of all types have a lower annual interest rate than longer-term bonds do. This lower discount rate means that those companies would have to have proportionately more assets available to pay pension benefits. Companies with younger workers could use a longer corporate bond rate, which would allow them to have proportionately less cash and other assets available. This is an important reform that should be carefully considered.

The simple fact is that some industries and companies have workforces that are older on average than others. Since these companies will have to begin paying their workers' pension benefits sooner, the health of their pension plans is a significant factor in their ability to remain in business. If their pension plans are underfunded and the company has to make significant payments to them, that company is at a higher risk of bankruptcy than if the same company had a younger average workforce. Rather than using a uniform measure for all companies, it is much more prudent to use a discount rate that is customized to reflect a particular company's workers.

Using a customized discount rate as proposed by the Treasury Department would allow workers and investors to better understand a company's overall financial health. The customized discount rate also should allow earlier identification of problem companies so that changes can be required before they become critical.

Balancing the Interests of Workers, Companies, and Taxpayers

It is tempting to see the issue of discount rates as affecting only the amount that cash-strapped companies will have to divert to their pension plans. However, much more is at stake. Changing the discount rate to just a single long-term corporate rate might benefit companies by lowering the amount that they have to contribute to pension plans, but it also might hurt both workers and taxpayers in the long run. Workers who want to take a lump-sum pension distribution instead of monthly payments would receive less under such a system than they would under the current discount rate.

Lump-sum pension benefits are calculated by determining the total amount of pension benefits owed over a lifetime and calculating how much money invested today at the discount rate is needed to grow into the promised total amount. The higher the discount rate, the lower the amount of money that will be necessary to grow into that promised benefit, and the lower the lump sum benefit. At the same time, too low a discount rate may mean a lump-sum payment that is too high, thus further draining the plan of needed assets.

In determining an appropriate discount rate, Congress must balance the needs of both pension plans and retirees wishing to take a lump sum benefit. Similarly, if Congress

only substitutes a higher uniform discount rate for the present one, taxpayers could find themselves required to pay higher taxes to make up for Pension Benefit Guarantee Corporation (PBGC) deficits. The PBGC is the federal insurance agency that takes over insolvent pension plans and pays benefits to retirees. Even though the PBGC limits the amount that it pays to each retiree, taxpayers can expect Congress to bail out the agency with additional tax money if the agency runs major deficits.

When Congress considers the appropriate discount rate, it must take into consideration the risk that an overly generous discount rate will result in more underfunded pension plans, and thus that more of those plans will be turned over to the PBGC for payment. This is not just an issue that concerns companies; taxpayers have an equal stake in its outcome.

Two Other Important Reforms

The Treasury Department proposal includes two additional reforms that would increase the information available to workers and investors and lower the potential liability to the PBGC. Even if agreement on the discount rate cannot be reached for now, Congress should swiftly consider making the following reforms:

1. Improved Information

All too often, the true status of a defined benefit pension plan is unknown to the affected companies' workers and investors. The Treasury Department proposal would require pension plans that are underfunded by more than \$50 million to make a more timely and accurate disclosure of their assets, liabilities, and funding ratios. In addition, while phasing in the new discount rate changes, all plans would have to make an annual disclosure of their pension liabilities using the duration matched yield curve. This reform would further improve the ability of workers and investors to judge whether a pension plan is properly funded.

Finally, pension plans would have to disclose whether they have enough assets available to pay the full amount of benefits that workers have already earned. Known as "termination basis," this method ensures that if the company files for bankruptcy and seeks to terminate its pension plan, workers are not suddenly surprised to find that the plan cannot pay the pension benefits they have already earned.

2. Reduced Taxpayer Liability

Companies that are in severe financial trouble often try to keep their workers happy by promising them higher pension benefits. Similarly, companies in bankruptcy sometimes seek to improve pension benefits in return for salary concessions. In both cases, these higher pension promises often get passed on to the PBGC, and thus to the taxpayers, for payment when the company seeks to terminate its pension plan. The proposed reforms would prevent severely underfunded pension plans from promising higher pension benefits or allowing

lump-sum payments unless the company fully pays for those improvements by making additional contributions to its pension plan. Similar restrictions would apply to companies that file for bankruptcy.

How Not to Improve the Situation.

The one thing that Congress should not do is to repeat the sad experience of the 1980's. Unless there is hard evidence that a company will recover its economic health, Congress should not casually extend the amount of time that corporations have to fund their pension plans. While this may be justified on a case-by-case basis, a general rule is likely to just mean that taxpayers will have to pay more to bail out the PBGC when it runs out of money.

And that day is inevitable unless Congress takes a serious look at PBGC and the entire retirement situation. This is not a problem where individual mini-crises should be considered to be unrelated. PBGC has an investment portfolio that includes a sizeable proportion of government bonds. It is true that unlike Social Security, which receives special issue treasury bonds that cannot be traded on the open market, PBGC can and does build its portfolio by trading its bonds on the open market. However, that activity gives a false sense of assurance.

When the time comes for PBGC to liquidate its portfolio to pay benefits, we may see the "perfect storm" where both Social Security and Medicare are liquidating their government bond portfolio at the same time. Even though PBGC is the smallest of these agencies by a large margin, the only way that it will be able to raise the money that it needs for benefit payments is to either sell its bond portfolio on the open market or to return them for repayment. Neither option looks promising at this point. If the government is borrowing massive amounts of money, the prices of bonds can be expected to be unstable at best. And if Social Security and Medicare are consuming massive amounts of government resources, PBGC can expect a place behind them.

Thoughts for the Future.

As an alternative, Congress should consider a close examination of the entire retirement situation ranging from Social Security to private pension plans to incentives for people to work. Among steps that could be considered are:

1. **Reform PBGC:** PBGC has done a fine job with what it has, but the structure is fundamentally flawed. Premiums are inadequate, and are not based on any measure of the risk that the employer will turn its pension plan over to the agency. Investment strategies are less than adequate. Rather than a piecemeal review, Congress should begin now a thorough review of the agency .
2. **Encourage Small Business to Form Retirement Pools:** About 50 percent of the US workforce has no private pension plan. Many of these workers are employed by smaller businesses that cannot afford to sponsor any sort of retirement plan. Current legislative efforts to remedy this situation have centered on reducing the

regulatory burden that is a major part of the cost of having a pension plan. Instead, Congress should consider an alternate approach. Rather than expecting every small business to have its own retirement plan, encourage them to form pools, perhaps based around associations, chambers of commerce, or other affinity group. This would work best with defined contribution retirement plans.

3. **Phase Out Defined Benefit Plans:** Sadly, it may be time to recognize that in the future workers will have more job mobility than they even do now, and that a defined benefit plan may not be in their best interests. Congress should consider developing incentives for companies to shift their retirement plans to defined contribution plans.
4. **Encourage Workers to Work Longer:** In the future, there will be fewer younger people to take the jobs of those who retire, and a resulting demand for older workers who are willing to stay in the workforce – even if it is only on a part-time basis. Congress should examine the various workplace rules now to remove regulatory and other obstacles
5. **Reform Social Security:** Every day that Congress and the Administration delays reforming Social Security, there is one less day that the program will have surpluses. The Social Security trustees warn that the program will begin to run cash flow deficits within 15 years. There is a pool of IOUs known as the trust fund, which can be used to help pay benefits until they run out in 2042, but in order to liquidate them, Congress will have to come up with about \$5 trillion (in today's dollars) from general revenue. The last thing that future retirees need is to find out that both their company pension plan and Social Security are unable to pay all of their promised benefits.

Thanks you for the opportunity to testify. I look forward to your questions.

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(C)(3). It is privately supported, and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2002, it had more than 200,000 individual, foundation, and corporate supporters representing every state in the U.S. Its 2002 contributions came from the following sources:

Individuals	61.21%
Foundations	27.49%
Corporations	6.76%
Investment Income	1.08%
Publication Sales and Other	3.47%

The top five corporate givers provided The Heritage Foundation with less than 3.5% of its 2002 income. The Heritage Foundation's books are audited annually by the national accounting firm of Deloitte & Touche. A list of major donors is available from The Heritage Foundation upon request.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own, and do not reflect an institutional position for The Heritage Foundation or its board of trustees.

The CHAIRMAN. David, thank you very much.

Talking about understanding and transparency, and the knowledge of how to deal with it if you are on the receiving, or if you are on the losing end, of a plan that is in trouble, let me turn to Melvin Schmeiser, a retired steelworker from Baltimore who I understand found himself in that kind of situation. Melvin, please proceed with your testimony.

**STATEMENT OF MELVIN SCHMEISER, STEELWORKER
RETIREE, BALTIMORE, MD**

Mr. SCHMEISER. Good morning, Mr. Chairman and members of the Senate Special Committee on Aging. My name is Melvin Schmeiser. I am 56 years old and a retiree of the Bethlehem Steel Corporation after 35.5 years of service. My full testimony has part of my work history and a description of some of the hazards of working in the steel mill.

I was married in 1981 to my wonderful wife Alice and also found out there was a lot more overtime available if I volunteered for shift work. As a turn millwright, you could be assigned jobs anywhere in the coke oven area. It seemed in the winter is when you would be sent on top of the coal bridge cranes at 2 a.m. and the tears from the wind would freeze on your cheeks. In the summer, you would be sent on top of the ovens. You would have to wear wooden clogs strapped to your safety shoes so they would not catch on fire. You had to wear a respirator to protect your lungs from the thick yellow smoke. Sometimes you were sweating so bad you could see the bubbles coming out of the mask. This is where the money was.

This was also about the time when I started to think about retirement. Under the contract there were two ways to determine how much pension an hourly employee would receive. Option one, years of service multiplied by a dollar amount. This was OK if you worked 40 hours a week or missed some time due to layoffs or sickness.

Option two, years of service times a percentage of the amount of money you made over a 60 consecutive month period during the last 10 years of service. If you can stay healthy, not miss any time on the job, and a fair amount of overtime was available you could greatly enhance your retirement pension.

In 1989, the coke ovens were shut down and I was back on the street again. After several weeks I was able to use my plant seniority to bump back into various labor and mechanical pools. In 1991, jobs were opened up in several mechanical departments and I bid into the cold sheet mill.

When I arrived, I was told I would not like it there because it was hot in the summer, cold in the winter, and greasy. Compared to some of the places I had worked in the past, this was like an office job. You could actually see from one end of the building to the other with just a few wisps of steam. It was turn work, but plenty of overtime.

About 1993, there was talk of a new state-of-the-art cold rolling mill that Bethlehem wanted to build. It would only need about half the employees of the current facility if job combinations were instituted. If the new mill was to be built at Sparrow's Point, the union

would have to make concessions. The union agreed to job combinations if the company would offer the displaced employees a \$400 a month bonus upon retirement. The mill was built at Sparrow's Point.

My wife and I decided with the \$400 a month increase in my pension until I reached age 62, and working all of the overtime I could physically handle, we should be able to live comfortably the rest of our lives. I had worked a fair amount of overtime in the past to pay our house off, and car loans early. We had a plan to work for a good retirement and be worry free in our old age.

I worked shift work most of my 35 years at the Point. It was hard on both of us. My wife referred to herself as a Bethlehem Steel widow at family functions that she had to attend alone.

Years ago we started some IRAs and I had a 401(k) plan. There were no matching contributions from the company. We also had some certificates of deposit and money in regular bank accounts.

Bethlehem offered free retirement classes on company property with outside experts on investments and Social Security. I attended the two night 2 hour classes and we decided that we were financially secure. I also started going over the retirement and medical benefits books we received after every new contract.

In 2000, retirement meetings were held on company time where Bethlehem representatives gave pension estimates and answered questions. There was a union representative at the meetings. They assured us that if things got bad for the company, the company could not get its hands on the pension fund and that there were hundreds of millions of dollars in the fund. He said the sky would have to fall for the fund to be depleted. Even if it did, the Federal Government would pay you 85 percent of your pension if you were 55.5 years old. So I retired February 28, 2001.

Well, the sky did fall. The company filed for Chapter 11 bankruptcy protection and later was sold to International Steel Group. Bethlehem Steel was forced into bankruptcy because of the broader crisis affecting the steel industry brought on by a flood of dumped foreign steel which caused domestic prices to collapse. The new company, ISG, would not be responsible for Bethlehem's legacy cost, which included pensions, life insurance, and health care for the retirees.

On December 18, 2002 the Pension Benefit Guarantee Corporation took over the pension fund. So my \$2,450 regular monthly pension plus the \$400 a month bonus will be reduced to less than \$1,700 a month. While I am disappointed by how much my pension is being reduced, I realize that without ERISA I would have no pension left at all.

My medical insurance, which was costing me \$165 a month for both my wife and I will now cost \$1,028 a month. Fortunately, I can use the health insurance tax credit which will cover 65 percent of my payments. My out-of-pocket payments will be reduced to \$357.80 a month unless the rates increase.

This, I hope, will last until I am 65 and I hope Medicare will still be available. I hope prescription drug coverage will also be a part of Medicare by then. Finally, I hope that Social Security will be available when I am 62.

Thank you.

[The prepared statement of Mr. Schmeiser follows:]

Testimony of
Melvin Schmeizer
Retiree
Bethlehem Steel Corporation

Before the U.S. Senate
Special Committee on
Aging

October 14, 2003

Good morning Mr. Chairman and members of the Senate Special Committee on Aging. My name is Melvin Schmeizer. I am 56 years old and a retiree of the Bethlehem Steel Corporation after 35 and a-half years of service.

Two weeks after graduating from high school in June of 1965, I started work at Sparrow Point plant in Baltimore, Maryland. I was assigned to the operation section of the steam department. The work wasn't real hard or dirty, but I had would have had to work shift work my entire career. Ten months later there was an opening for a mechanical helper in the coke oven department. This department rarely laid off, worked mostly daylight hours and paid more money. I was assigned to the coal chemical section of the coke ovens. This area removed chemicals from the gas that came off the batteries of coke ovens and cleaned it to be reused as fuel. Most of my first 15 years in the coal chemical area were spent at the Litol plant.

This facility used a high pressure and high temperature process that produced benzene. This was a particularly hazardous area because of the pureness of the carcinogen

benzene and the possibility of fires and explosions. Two employees were killed on the job by two separate explosions. I was burned by hot oil in 1979 and spent 28 days in the city hospital burn unit. All in all, I thought this was one of the better places to work in the coke ovens. During this period, there was one major plant layoff and I was on the street for 10 months. Later I was able to bump back in to various labor pools for another 14 months. I was also able to advance my job classification from Mechanical Helper to Millwright A. I was married in 1981 to my wonderful wife Alice and also found out there was a lot more overtime available if I volunteered for shift work.

As a turn Millwright, you could be assigned jobs anywhere in the coke oven area. It seemed that in the winter is when you would be sent atop of the coal bridge crane at 2 a.m. and the tears from the wind would freeze on your cheek. In the summer, you'd be sent on top of the oven. You would have to wear wooden clogs strapped to your safety shoes so they would not catch on fire. You had to wear a respirator to protect your lungs from the thick yellow smoke. Sometimes you were sweating so bad, you could see bubbles coming out of the mask. This was where the money was.

This was also about the time when I started to think about retirement. Under the contract, there were two ways to determine how much pension hourly employees would receive.

Option 1: years of service multiplied by a dollar amount. This was okay if you worked 40 hours a week or missed some time due to layoffs or sickness.

Option 2: Years of service times a percentage of the amount of money you made over a 60 consecutive month period during your last ten years of service.

If you could stay healthy, not miss any time on the job, and a fair amount of overtime was available, you could greatly enhance your retirement pension.

In 1989, the coke ovens were shut down and I was back on the street again. After several weeks, I was able to use my plant seniority to bump back into various labor and mechanical pools. In 1991, jobs were open in several mechanical departments and I bid into the cold sheet mill.

When I arrived, I was told I would not like it there because it was hot in the summer, cold in the winter and greasy. Compared to some of the places I had worked in the past, this was like an office job. You could actually see from one end of the building to the other with just a few wisps of steam. It was turn work, but plenty of overtime.

At 1993, there was talk of a new state of the art cold rolling mill that Bethlehem wanted to build. You would only need about half of the employees of the current facility if job combinations were instituted. If the new mill was to be built at Sparrow's Point, the union would have to make concessions. The union agreed to job combinations if the company would offer the displaced employees a \$400 a month bonus upon retirement. The mill was built at Sparrow's Point.

My wife and I decided with a \$400 dollar a month increase in my pension until I reached age 62 and working all of the overtime I could physically handle, we should be able to live comfortably the rest of our lives. I had worked a fair amount of overtime in the past to pay off our house and car loans early. We had a plan to work for a good retirement and be

worry free in our old age. I worked shift work most of my 35 years at the Point and it was hard on both of us. My wife referred to herself as a Bethlehem Steel widow at family functions that she had to attend alone.

Years ago, we started some IRAs and I had a 401(k) plan. There was no matching contributions from the company. We also had some certificates of deposit and money in regular bank accounts.

Bethlehem offered free retirement classes on company property with outside experts on investments and Social Security. I attended the two-night two-hour classes and we decided we were financially secure. I also started going over the retirement and medical benefits books we received after every new contract.

In 2000, retirement meetings were held on company time where Bethlehem representatives gave pension estimates and answered questions. There was a union representative at the meeting. They assured us that if things got bad for the company, the company could not get it's hands on the pension funds and that there were hundreds of millions of

dollars in the fund. He said, "The sky would have to fall for the fund to be depleted and even if it did, the Federal government would pay you 85 percent of your pension if you were 55 and a half years old." So I retired on February 28, 2001.

Well, the sky did fall. The company filed for Chapter 11 bankruptcy protection and later was sold to International Steel Group or ISG. Bethlehem Steel was forced into bankruptcy because of the broader crisis affecting the steel industry, brought on by a flood of dumped foreign steel which caused domestic prices to collapse. The new company, ISG, would not be responsible for Bethlehem's legacy costs which included pensions, life insurance, and health care for the retirees. On December 18, 2002, the Pension Benefit Guarantee Corporation or PBGC took over the pension fund. So my \$2,450 regular monthly pension plus \$400 a month bonus will be reduced to less than \$1,700 a month. While I am disappointed by how much my pension is being reduced, I realize that without ERISA, I would have no pension left at all. My medical insurance, which was costing me \$165 a month for both my wife and I will now cost \$1,028 a month. Fortunately, I can use the health insurance

tax credit or HITC which will cover 65 percent of my payment. My out of pocket payments will be \$357.80 a month unless the rate increase. This I hope will last us until I am 65 and hope Medicare will still be available. I hope prescription drug coverage will also be a part of Medicare by then. Finally, I hope Social Security will be available when I'm 62.

Thank you.

The CHAIRMAN. Melvin, thank you for that very clear testimony. While obviously you in your life have been a very hard-working person, you have also been a thinking person the way it sounds as it relates to you and your wife's future and your retirement plans.

Scott, let me come to you for some questions and to David, and back to you, Melvin.

Scott, in your testimony you say that action to strengthen the defined benefit system must be taken now in the form of a replacement interest rate for the 30-year treasury bond. How does reducing the cash put into pension funds, many of them at risk, strengthen the defined benefit system?

Mr. MACEY. Before I answer that, Mr. Chairman, I just wanted to say after listening to Mr. Schmeiser's story, he had a much tougher job than I have ever had and probably about one of your years in your career was worth about four or five of what I do. So I commend you for seeing through a very tough job.

First, I think most obviously if companies are required to put in cash into plans that do not reflect the true and reasonable measure of the liabilities of the plans, they are just not going to support the system. So No. 1, the most obvious way that using an accurate or a better measure of interest rates and better measure of determining what pension liabilities and plan contributions should be encourages defined benefit plan sponsors to stay in the system. So that certainly would help to strengthen the system.

We are looking at a situation now where yes, there is some underfunding in a number of pension plans. Some have significant underfunding. But we are looking at them as they come out of the trough of a difficult economic cycle coupled with very low interest rates in measuring the liabilities. It is almost, between the economic cycle, the loss of market value in plan assets from three or so years ago, and the very low interest rates, the perfect storm for measuring liabilities.

So what we are saying in a number of different ways and respects is, No. 1, let us not act precipitously to impose new burdens on employers as they come out of the economic cycle. No. 2, the corporate bond rate is certainly a more accurate measure than a defunct U.S. Treasury rate that is at the lowest, the Treasury rates are at their lowest point in over 50 years. So our measure of it, we think, strengthens the defined benefit system.

What we need to do overall is take action beyond the corporate bond rate replacement. I think there seems to be very little debate over moving from a Treasury rate to a corporate bond rate. The debate seems to be should other things be tacked onto it. Perhaps they should and perhaps they should not, but not enough study and evaluation about the impact of some of the other suggestions coming from the administrative agencies that are responsible for overseeing ERISA and pension plans has been done.

What we do have is, at least on one item, common agreement. That is let us act now to replace the defunct 30-year treasury rate with a reasonable high-grade mix of corporate bond rates that is very transparent and not subject to manipulation.

Some of the other steps that could be taken to strengthen the system is to finalize these regulations regarding hybrid plans at Treasury. I think several of the witnesses have mentioned that hy-

brid pension plans are—in addition to myself and the organizations I represent—are one of the positive steps in defined benefit plans. Unless we make the system more flexible so that employers and employees together—and many unions have agreed to support hybrid pension plans—unless they can work together to come up with new and innovative plan designs, I think we are going to see continued plan freezes and plan terminations to the detriment of the retirement system and the retirement security of millions of Americans.

The CHAIRMAN. Scott, what are industries now doing to increase transparency and disclosure of pension fund solvency to workers, especially for the at-risk plans? Is there any movement internally to do that? Or are we going to have to force it?

Mr. MACEY. Mr. Chairman, I guess industries are looking at providing and wish to provide relevant, meaningful, accurate, and timely information to all of the different constituencies that may be interested in that. One is the Government, another is employees, and another are shareholders. Now the same information may not be relevant to all of those different constituencies.

What industry does not want to do is use inaccurate measures of supposed plan transparency information and provide that to participants. Several of the measures that the Government witnesses mentioned, specifically I believe Mr. Kandarian, was No. 1, provide plan termination information to participants.

We believe that that would be detrimental to the average plan participant because plan termination information is, in our minds, not an accurate measure of a long-term plan obligation. The pension plans are long-term obligations settled over many years. The typical earning the benefit and distribution timeframe is 40, 50 or 60 years. What the termination liability reflects is what is the value of all of that at a specific moment in time based upon specific asset values at that time, which may be at the trough of an economic cycle, and also the interest rates at that time.

We believe that plan termination type of information is not the type of information that would be helpful in a typical situation to the average plan participant.

The other suggestion that Mr. Kandarian mentioned was providing this so-called 4010 information, and that is the provision in ERISA that requires companies that have \$50 million worth of aggregate underfunding in all of their pension plans to file a report with the PBGC. By law that report is not disclosed to the public.

If information is to be disclosed to the public, then it should be relevant and meaningful information. A company with \$49 million worth of underfunding in a relatively small plan would not have to file that report. But a company with \$50 million worth of underfunding but billions and billions and billions of dollars in multiple plans would have to file that report.

So until at least the statute is corrected to provide a more meaningful measure of when a plan or a company truly has a significant unfunded liability, we do not think it would be appropriate to disclose to the public at all.

The CHAIRMAN. Last question of you, Scott. Your testimony states the Administration's yield curve proposal is too volatile. What do you mean by that?

Mr. MACEY. Well, it is a spot rate proposal that looks at rates over a short period of time. It is subject to change rather dramatically over relatively short periods of time. I think the absolute biggest problem that we have with the yield curve concept is we disagree wholeheartedly with the statement that it is a well-tried concept. It may be well-tried in some other avenues unrelated to pensions, but it is absolutely untried with respect to pensions. The Administration itself, in the testimony today and elsewhere in testifying before other committees before Congress, has indicated that a lot of work still needs to be done to answer a lot of specific questions about how the yield curve concept would be constructed and applied to pension plans. No one has determined what the impact of using a yield curve concept would be on pension plans.

My own feeling, having worked in the industry for 30 years now, is that we need to look at a lot of issues. How would companies respond to a yield curve concept if it is ultimately adopted? How should the yield curve be constructed and applied? What type of smoothing techniques should be developed to avoid the volatility?

For a very minor incremental aspect of accuracy, which can be challenged but let us grant that there is some minor aspect of increase in accuracy, what we are adding is we are charting waters in a totally unknown environment. Not one person from the pension industry has come forward and said we believe a yield curve concept make sense. That right there causes me great cause for concern.

Second, the yield curve concept is—no one has tested whether it would change employment patterns? Would industries with older workers freeze their plans because of the increases in contributions? Why are we using a yield curve when pension funding is generally a long-term concept anyway? It seems to me that all of these issues that have been raised by the Administration, assuming that they deserve legitimate or deserve significant review, should be reviewed in detail before Congress puts any proposal or adopts any proposal in its legislation to fix the anomaly of the 30-year treasury rate now.

So we oppose including that in the legislation for these reasons. We do suggest that the Government establish a commission to study the issue. I know that some people do not feel that is an appropriate approach in certain other areas of Government, to establish a commission. But quite frankly, a commission of interested and informed parties, who have a significant interest in the health and vitality of the defined benefit system, including people from Government, the investment community, participants and unions, and the employer community, and expert actuaries and others on that commission. Then we can respond to the yield curve concept and Congress could act in a more appropriate and responsible fashion.

The CHAIRMAN. Scott, thank you.

David, I am going to go immediately to you with a similar kind of question. Scott has talked about some of the problems they see in it. Critics are suggesting, and you did mention one, that it would discriminate against older workers. Discuss, if you would with us your view of the yield curve and some of its positives versus negatives?

Mr. JOHN. I think the question really has to be answered in terms of what you think discrimination is. To me the biggest form of discrimination against an older worker that we see is in the current system where you can work for 35 for 40 years, you can retire with a set promise of what your benefits are going to be, and you can wake up one morning and discover that your life has been completely turned upside down and that what you had been led to believe does not exist.

A yield curve is a new and different form of looking at pension financing. It has not been implemented, as far as I know, in any pensions at this point. However, the simple fact is that this is not just a matter of dealing with numbers on a page. This is dealing with lives. This is dealing with the ability to live a comfortable and reasonably secure retirement.

If a plan is frozen, and the Government's proposal does provide for freezing plan participation if plans are underfunded by a certain level, may actually prove to be a good thing. In most of the studies of current problems with defined benefit pension plans, the experts say that you can pick out the companies that are going to turn their pensions to the PBGC long in advance because their bonds are a junk bond rate for significant period of time.

If that is the case, and if it is possible to identify these plans early, as it is, and if it is possible to use a yield curve to add additional information to that, and it is further possible to prevent them from becoming at some point further underfunded; i.e., that the retirees who depend on them are going to be in even worse shape than they are now, or the taxpayers who are going to have to pick up some of those promises will end up paying more, then I think that is actually a small price to pay.

The CHAIRMAN. The Administration has proposed improved disclosure rules for the workers. Will the benefits exceed the cost of these additional rules?

Mr. JOHN. Yes, I think they will. The costs are not going to be insubstantial. As one who is at the Heritage Foundation, we would never think lightly of anything that would increase regulatory cost.

What is a very serious problem however is to have workers who are 20 or 30 years in their careers with a particular company and to wake up one day and discover, as I said before, that their lives had been turned upside down.

Now one of the things that I think is interesting is there is always a discussion about what information is meaningful.

The CHAIRMAN. We just heard Scott walk through several iterations of what is meaningful to whom. I would appreciate your version of that.

Mr. JOHN. Meaningful is in the eye of the recipient when it comes down to it. It may well be that plan termination basis is not the best and most accurate method to give to a worker. At the same time, it raises a certain level of questions that need to be answered. It would be possible to provide workers with information on their defined benefit pension plans that actually does answer their questions. I do not know that plan termination is necessarily one of them, but I do believe that they need to have some idea as to how far their pension is underfunded.

If it is significantly underfunded, well frankly, they should know that they are at decent risk.

Now the \$50 million level is something I also happened to agree with Scott on. That is an absolutely arbitrary level and as inflation goes, it is going to be less and less meaningful. It would be far better to change that into some form of a percentage underfunded rate. Something that a pension plan, if they are say 20 percent underfunded then these additional disclosures would be triggered.

But one way or the other, again this is not just a matter of numbers and words on a page. This is people's lives. It is also a matter that if these promises are not kept, then either people like Mr. Schmeiser are going to pay for it directly or essentially, as legislators, you are going to find yourself with additional demands on the Federal treasury to help bail it out. Neither is exactly fair to be uninformed about.

The CHAIRMAN. David, your testimony states that defined benefit plans may not be in the best interests of workers. This idea seems to be in conflict with Scott's testimony pointing to the possibility of vibrant and growing defined benefit systems.

What do you know that Scott does not know? Scott, you can do a follow-up.

Mr. JOHN. This should be fun.

When I was doing my economic studies, we talked about a curve which—this was one of my favorite semi-nonsensical terms. It was increasing at a decreasing rate. What we are seeing with defined benefit pension plans is, as has already been said, we are having fewer and fewer plan sponsors even though the number of participants is increasing slightly.

A defined benefit plan makes a great deal of sense for a model of employment that fits, say my father, who was a professor and in his post-World War II career held a grand total of two jobs once he got out of graduate school.

If you listen to the criteria that Mr. Schmeiser mentioned, for instance in particular the one the last 60 months of employment is a determination of your pension plan, it does not work if an average worker—and I am thinking in particular of younger workers. I have got a 17-year-old daughter who is about to go off to college. The studies show that she, on average, can expect to have something like 10 or maybe even 12 different employers. So by the time she reaches her last 60 months, that may be the only 60 months issues that she is with that particular employer.

As we see increasing movement in the workforce, as we see an increasing demand for older workers to remain in the workforce simply because there are not enough young people to replace them as time goes on, I think we are going to see the whole pension structure shift. It does not make much sense in a multiemployer, serial employer actually, system to have a defined benefit pension plan. A defined contribution plan is much more advantageous because you can take your assets with you from one place to another.

Similarly, I do not know that in the future, and this may even be at the time that I retire, that we are going to see older workers who retire and totally stop working. It may well be because we have a certain level, hopefully, of expertise and needed skills that we will come back and work on a part-time basis. So our retire-

ment would be a mixture of earnings, pension plans, Social Security, assuming that gets fixed, and various other methods.

The CHAIRMAN. Five words are less, Scott. Our time is short and I do want to get to Mr. Schmeiser.

Mr. MACEY. Absolutely.

I think historically the best experience for retirement security is probably a mixture of defined benefit and defined contribution plans where there is somewhat of a shared responsibility between the company and the individual. But certainly, defined benefit plans offer individual workers the benefit guaranties subject to obviously some situations like Mr. Schmeiser's where a part of the benefit is lost. The employer assumes the total investment risk and there are lifetime annuities provided by the plan.

Now you have mentioned final pay-type plans and workers moving from one company to another do not fit the model of a typical DB plan. But that is why employers have innovated in recent years with defined benefit plans such as cash balance plans and pension equity plans that provide for greater portability. Certainly, transparency is enhanced because then the employee knows exactly what their account balance is at any time under a cash balance plan.

The GAO witness, I am not going to attempt to pronounce her last name, she mentioned that innovation in pension plan design is an important aspect of the health and vitality of the pension system. I think that we in industry believe wholeheartedly in that and have been attempting to respond favorably with innovative plan designs that are responsive to the needs of the business and balance the interests and concerns of employees.

I would mention just again that we hope that the Government can issue its guidance that we have been waiting for for a long time to make sure that we can continue to sponsor and develop these plans.

The CHAIRMAN. Gentlemen, thank you.

Mr. Schmeiser, you did everything right, it appears, in planning your retirement. You saved for retirement in an IRA, you funded a 401(k) retirement account, you worked very hard to build the value of your pension retirement, you paid off your home mortgage.

Given your experience, what would you advise young people thinking about planning for their retirement in the context of what you have just heard?

Mr. SCHMEISER. Well, I think it would be very advantageous to start putting money away for your retirement as early as possible, and to diversify where you did put your money just in case one area did not do so well.

The CHAIRMAN. Based on what you have just heard, but more importantly what you have just experienced, if you had had additional information, a greater understanding of the pension plan of Bethlehem, that it might be in trouble, or that certain aspects of it were not creating the kind of solvency that would produce the payment of pension that you were anticipating prior to or in advance of your notification, would that have been a benefit to you? How would you have handled it? Have you thought that one through?

Mr. SCHMEISER. It certainly would have been a benefit. I would still be working. I would not have retired.

The CHAIRMAN. You would have made different kinds of decisions about your not only working but your retirement plans?

Mr. SCHMEISER. Yes, sir.

The CHAIRMAN. In other words, information would have been extremely valuable to you in your planning?

Mr. SCHMEISER. It certainly would have been.

The CHAIRMAN. Thank you.

Gentleman, thank you all very much for your testimony. I hope we have built some valuable record today. We appreciate it.

The committee will stand adjourned.

[Whereupon, at 11:53 a.m., the committee was adjourned.]

A P P E N D I X

PREPARED STATEMENT OF DEBBIE STABENOW

Chairman Craig, thank you for convening a hearing on this difficult issue. I also want to thank all the witnesses for being here and helping us build a legislative record. Protecting the retirement income of American workers should be a priority of this Administration.

Too many Americans watched their retirement incomes shrink as the stock market dropped dramatically over the past two years. Hard working Americans who carefully planned for retirement are now facing—through no fault of their own—less than secure futures.

In addition to the slumping stock market, our lethargic economy has resulted in many manufacturing companies closing their doors or filing bankruptcy, leaving the Pension Benefit Guarantee Corporation to take over these companies' pension plans. My great state of Michigan—with its proud manufacturing tradition—has been especially hard hit during this economic downturn. To date, the PBGC is trustee for over 200 pension plans from companies formerly headquartered in Michigan.

The Pension Benefit Guarantee Corporation was created by Congress in 1974 to help insure retirees pension benefits. With the escalating obligations facing the PBGC, its own standing has been deemed "high risk" by the General Accounting Office. Congress is currently considering several proposals that will provide assistance to companies struggling to meet their pension obligations. It should go without saying that these proposals must also work to protect the retirement security of American workers as well as avoiding a bailout of the PBGC by taxpayers. Moreover, any changes to pension laws sanctioned by Congress must be more than simply accounting sleight-of-hand tricks like those used recently by private corporations.

Again, thank you Chairman Craig for convening this hearing. I look forward to hearing from our witnesses.

